Supreme Court, U. S.
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IN THE

Supreme Court of the United States

No. 78-1694

C. DOUGLAS WILSON & COMPANY,
a South Carolina Corporation,

Petitioner,

versus

INSURANCE COMPANY OF NORTH AMERICA, Philadelphia, Pennsylvania; HARTFORD ACCIDENT AND INDEMNITY COMPANY, Hartford, Connecticut; and ST. PAUL FIRE AND MARINE INSURANCE COMPANY, St. Paul, Minnesota,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

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PETITION FOR A WRIT OF CERTIORARI

The petitioner C. Douglas Wilson & Co. prays that a writ of certiorari issue to review the decision and judgment of the United States Court of Appeals for the Fourth Circuit, dated and entered in this case on January 10, 1979.

OPINIONS BELOW

The Opinion of the District Court for the District of South Carolina, which is reported at 464 F.Supp. 1, is printed as Appendix A to this Petition.

The Opinion of the Court of Appeals for the Fourth Circuit, together with the dissenting Opinion of Judge Walter E. Hoffman (sitting by designation), which are reported at 590 F.2d 1275, are printed as Appendix B to this Petition.

The Petition for Rehearing filed by Petitioner is printed as Appendix C to this Petition and the Order of the Court of Appeals denying the Petition for Rehearing (with Judge Hoffman dissenting) is printed as Appendix D to this Petition.

JURISDICTION

The judgment of the Court of Appeals was entered on January 10, 1979. A Petition for Rehearing was filed and was denied on February 21, 1979. The jurisdiction of this Court is invoked under the provisions of 28 U.S.C. § 1254(1).

QUESTIONS PRESENTED FOR REVIEW

I. Did the District Court and Fourth Circuit Court of Appeals violate the requirements of *Erie v. Tompkins* by granting judgment notwithstanding the verdict based upon their determination of certain questions of law without giving any consideration whatsoever to the way those questions would be answered under the law of South Carolina?

II. Was the determination of these questions of law by the District Court and the Court of Appeals contrary to the controlling law of the State of South Carolina, thereby requiring reinstatement of the jury verdict?

III. Did the District Court and the Court of Appeals, by setting aside the jury verdict without considering, and in violation of, the controlling law applicable to the case, deprive petitioner of its Seventh Amendment right to trial by jury?

IV. Do the facts of this case, as presented in the record and as determined by the jury verdict in favor of petitioner, require that judgment be entered in favor of petitioner upon the jury verdict?

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

United States Constitution, Amendment VII:

"In suits at common law, where the value in controversy shall exceed twenty dollars, the right of trial by jury shall be preserved, and no fact tried by a jury shall be otherwise re-examined in any court of the United States, than according to the rules of common law."

28 *U.S.C.* § 2160:

"The Supreme Court or any other court of appellate jurisdiction may affirm, modify, vacate, set aside or reverse any judgment, decree, or order of a court lawfully brought before it for review, and may remand the cause and direct the entry of such appropriate judgment, decree or order or require such further proceedings to be had as may be just under the circumstances."

STATEMENT OF THE CASE

Petitioner C. Douglas Wilson & Co. instituted a declaratory action (with jurisdiction based on diversity of citizenship) against Insurance Company of North America ("INA"), Hartford Accident & Indemnity Insurance Company ("Hartford"), and St. Paul Fire & Marine Insurance Company ("St. Paul"), to determine the defendants' liability under their Banker's Blanket Bond coverages for losses sustained by petitioner as a result of the dishonesty of a vice president, J. L. Barksdale. The defense which is presently at issue was that petitioner had knowledge of prior dishonesty on the part of Barksdale which precluded coverage for the losses in question. The trial lasted approximately eight days and damages approximated $1.25 million, although the question of the exact

amount of damages was severed from the trial for later determination. Upon the conclusion of plaintiff's case, St. Paul was dismissed as a party defendant. The jury returned a verdict against INA and Hartford.

Petitioner had continuous fidelity bond coverage throughout the period in question. Petitioner had been acquired by NCNB Corp. by stock acquisition on August 16, 1972. On that date NCNB Corp. had in force and effect Banker's Blanket Bonds issued by INA and Hartford. The INA bond provided $8,000,000 coverage and had a $50,000 deductible provision, while the Hartford bond in turn provided coverage for this $50,000 deductible amount. The INA and Hartford bonds provided that coverage would automatically be extended to cover any corporation subsequently acquired by NCNB Corp. At the time of the stock acquisition, petitioner had in force and effect a fidelity bond issued by St. Paul, which was not due to terminate until March 25, 1973. Rather than having the St. Paul bond terminate early, it was agreed among agents of all parties that the St. Paul bond would remain in effect until its stated termination date of March 25, 1973, at which time the coverage of the INA and Hartford bonds would automatically take over.

Petitioner is a mortgage brokerage firm which began handling multi-family loans of the Department of Housing and Urban Development (HUD) in the late 1960's and eventually became extensively involved in such financing. The employee in charge of the HUD multi-family financing was J. L. Barksdale, who was the only employee of petitioner familiar with HUD regulations and the details of this financing. In handling the financing it was necessary for Mr. Barksdale to make advances to contractors in the course of construction and to file a form with HUD setting out the dates and amounts of such advances.

On March 16, 1973, in a routine credit review, Robert Shaw, an accountant with NCNB Corp., discovered variances in some of the figures as to loan advances on the certificates

which had been filed with HUD. He questioned J. L. Barksdale about these variances, and Barksdale explained that this was a common practice in the handling of loans of this type, that HUD knew of the practice, and that this was the custom and usage of the trade. Mr. Shaw prepared a memorandum concerning this information which he forwarded to his superior officers and which they reviewed on March 19. These officers without exception testified that they felt this was poor business practice on the part of Mr. Barksdale but that none of them had any thought whatsoever that it indicated dishonest conduct on his part. Six days later, on March 25, the St. Paul policy reached its expiration date and the INA and Hartford policies came into effect as to petitioner.

In April of 1973, petitioner discovered that letters of credit which were required to back up these HUD multi-family loans simply did not exist for many of the loans. Mr. Barksdale, who was responsible for seeing that these letters of credit were obtained, had falsely certified their existence to HUD and had represented to petitioner that they were being held in the office safe. This dishonesty by Barksdale ultimately resulted in the $1.25 million loss for which petitioner has made claim under the various fidelity bonds. Mr. Barksdale was subsequently indicted and pled guilty to criminal violations concerning his false certifications to HUD as to the letters of credit. Although there was an investigation by both the FBI and grand jury, Barksdale was not indicted for any criminal act relating to variances on his certifications as to the loan advances.

After a full trial of the issues, the jury returned a verdict for petitioner against INA and Hartford establishing that their fidelity bonds provided coverage to petitioner for these losses. Under the jury instructions, this verdict necessarily included findings by the jury (1) that the loss sustained by petitioner resulted from dishonest acts of Barksdale in connection with the letters of credit, and (2) that petitioner knew of no prior dishonest acts of Barksdale which would preclude coverage under the bonds.

After the jury verdict for petitioner, INA and Hartford made motions for a new trial and judgment n. o. v., which were heard in December of 1976. Judgment n. o. v. was granted by Order of the District Judge on July 6, 1977. Appeal was taken by petitioner to the Fourth Circuit Court of Appeals and the judgment n. o. v. was affirmed on January 10, 1979. Petition for Rehearing was duly filed and was denied on February 21, 1979.

REASONS FOR GRANTING THE WRIT

I. THE DECISION BELOW DISREGARDS FUNDAMENTAL PRINCIPLES OF DIVERSITY JURISDICTION REQUIRED BY ERIE R. CO. V. TOMPKINS BY FAILING EVEN TO CONSIDER SOUTH CAROLINA LAW AS TO DETERMINATIVE, SUBSTANTIVE LEGAL ISSUES.

The District Court, in granting judgment notwithstanding the verdict, relied upon several crucial statements of substantive law to justify the setting aside of the jury verdict rendered in favor of the petitioner upon the factual issues in the case. Although the Order of the Court contains confusing references to "the clear weight of the evidence" (Appendix A, p. A-21 and p. A-27), the District Court did *not* in fact hold that, as a matter of interpretation of the evidence presented, the jury could only have resolved the factual issues adverse to the petitioner. Instead, the Court withdrew certain questions from the province of the jury and held that they should be decided as a matter of law.[1] Among the alleged rules of law upon which the District Court relied in crucial portions of its order were the following:

> 1. In determining whether certain certifications by an employee were dishonest for purposes of establishing prior dishonesty of that employee, the District Court held *as a matter of law* that they must be considered dishonest because other certifications leading to the claimed loss were admitted by petitioner to be dishonest. The District Court held:
>
> > "There can be no distinction between the false certification on the mortgagee's Certificate and the false certification on the Request for Final Endorsement. If one is dishonest, then the other necessarily is also." (Appendix A, p. A-23.)
>
> 2. With regard to the equally critical question of whether petitioner (through its officers) had knowledge of any prior dishonesty of the employee, the District Court held *as a matter of law* that:
>
> > "[Petitioner] had knowledge of the false certifications as a matter of law and the false certifications were dishonest as a matter of law. Accordingly, [Petitioner] is charged with knowledge of [the employee's] dishonest conduct." (Appendix A, p. A-27.)

These crucial holdings have nothing to do with the sufficiency of the evidence to support the jury's factual determinations. Rather, they are conclusions of law by the District Court on the central issues of the case.

The Court of Appeals affirmed on the basis of the District Court opinion, adopting these statements of law (Appendix B, p. A-35). The outcome of the case is dependent upon each of these rules of law. If *either* is incorrect, petitioner is entitled to judgment on the jury verdict. Not only are they substantive rules of law, but they are "outcome determinative." *Guaranty Trust Co. v. York*, 326 U.S. 99, 65 S.Ct. 1464, 89 L.Ed. 2079 (1945). Yet, neither the District Court nor the Court of Appeals cites *any* South Carolina authority, or discusses in any way the controlling law of the state of South Carolina, with regard to these crucial legal principles relied upon to overturn the verdict of the jury.

The substantive law of South Carolina clearly must be applied in this diversity action. Judge Hoffman states this principle in footnote 1 (Appendix B, p. A-36) and footnote 13

[1] For example, the District Court holds that "[t]he testimony . . . does not make discovery a factual issue." (Appendix A, p. A-27.)

(Appendix B, p. A-44) of his dissenting opinion and discusses South Carolina authorities throughout that opinion. Neither the District Court nor the majority of the Fourth Circuit panel have challenged this principle; rather, they have simply ignored South Carolina authority altogether. Difficult as it may be to believe, the lengthy opinion of the District Court (Appendix A, pp. A-1 through A-28) does not even *mention* South Carolina law or discuss a single South Carolina authority. The majority opinion below likewise fails to acknowledge that the case is governed by South Carolina law and mentions no South Carolina authority on the crucial points set forth above; its only mention of a South Carolina case is to comment that one case cited by petitioner on a waiver issue "is inapposite." (Appendix B, p. A-35.)

Petitioner is entitled to have its case determined in accordance with South Carolina law, and the denial of that right offends perhaps the most important governing principle of diversity jurisdiction ever established by this Court. *Erie R. Co. v. Tompkins*, 304 U.S. 64, 58 S.Ct. 817, 82 L.Ed. 1188 (1938). "[I]n all cases where a federal court is exercising jurisdiction solely because of the diversity of citizenship of the parties, the outcome of the litigation in the federal court should be substantially the same, so far as legal rules determine the outcome of a litigation, as it would be if tried in a State court." *Guaranty Trust Co. v. York*, 326 U.S. 99, 109, 65 S.Ct. 1464, 1470 (1945).[2] In appropriate diversity cases, this Court has even required lower courts to stay their proceedings until important, unresolved questions of state law have been authoritatively determined by state courts, thus emphasizing the importance of the principles underlying the Erie Doctrine. *Kaiser Steel Corp. v. W. S. Ranch Co.*, 391 U.S. 593, 88 S.Ct. 1753, 20 L.Ed.2d 835

[2]Although *Guaranty Trust Co. v. York* has been limited by subsequent cases such as *Hanna v. Plumer*, 380 U.S. 460, 85 S.Ct. 1136, 14 L.Ed.2d 8 (1965), those cases have not changed this guideline as applied to substantive legal issues.

(1968); see *Louisiana Power & Light Co. v. City of Thibodaux*, 360 U.S. 25, 79 S.Ct. 1070, 3 L.Ed.2d 1058 (1959).

The best precedent for granting certiorari to review the present case is *Erie R. Co. v. Tompkins* itself, where the trial court and Court of Appeals affirmatively ruled that state law should not be applied and this Court granted certiorari and ultimately reversed the lower court decision. If the lower court here had ruled affirmatively that South Carolina law should *not* be applied, the violation of *Erie* would be so flagrant that certiorari would surely be granted. Should the lower courts be able to achieve the same result with impunity by the expedient of failing and refusing even to discuss whether South Carolina law should be applied? Petitioner respectfully suggests that the case does warrant the granting of a writ of certiorari by this Court to prevent such a result.

II. THE DECISION BELOW DECIDES IMPORTANT STATE QUESTIONS IN CONFLICT WITH THE APPLICABLE LAW OF THE STATE OF SOUTH CAROLINA.

The "rules of law" relied upon by the courts below are directly contrary to important, established principles of South Carolina law. First, the courts below have held that when false certifications are relied upon to establish employee dishonesty for purposes of the coverage provision of a fidelity bond, then, *as a matter of law*, other entirely different false certifications *must* be considered dishonest for purposes of policy exclusions under the same bond. Two separate and distinct policy provisions are involved, one defining coverage and the other specifying a policy exclusion. The law of South Carolina is clearly, concisely and unequivocally stated to the contrary in *Buddin v. Nationwide Mutual Ins. Co.*, 250 S.C. 332, 337, 157 S.E.2d 633, 635 (1967):

> The courts have uniformly held that where the clause is one of inclusion it should be broadly construed for the benefit of the insured while in exclusion cases the same clause is given a more restricted interpretation. (Citation omitted.) This is necessary

because in both situations the courts favor an interpretation in favor of coverage.

Likewise, the second "rule of law" relied upon by the courts below is contrary to South Carolina law. The District Court held that knowledge of facts later determined to constitute dishonesty as a matter of law would constitute *knowledge of dishonesty*, also as a matter of law, regardless of the actual state of mind of the officers of petitioner or the reasonableness of their subjective reaction. (By its verdict, the jury necessarily found that the officers of petitioner reacted as reasonable men when they believed the employee's plausible explanation of his conduct.) The South Carolina Supreme Court in the case of *Peurifoy v. Loyal*, 154 S.C. 267, 151 S.E. 579 (1930), faced a remarkably similar question and applied completely different legal standards in resolving it differently than would result from the District Court's rule. *Peurifoy* also involved an action on a fidelity bond. The plaintiff sought recovery for embezzlement by the president of a bank, and the surety contended that the bank had failed to give notice within ten days after discovery of the loss, thus raising (as in the present case) the critical question of time of discovery of the dishonest act. The uncontroverted evidence established that the president of the bank had misappropriated some $30,000 in negotiable bonds from the bank and pledged them as collateral for a personal appeal bond — a dishonest act far more flagrant than anything involved in the present case. It was also admitted that two uninvolved directors *knew this had been done*, although (as in the present case) they testified they did not consider it dishonest at the time. One director candidly admitted that "it didn't appear to me to be regular." (154 S.C. at 282, 151 S.E. at 584.) On appeal, the South Carolina Supreme Court *upheld a jury verdict* for the bank against the surety, holding (alternatively) that the knowledge of these directors did not constitute discovery of dishonesty as a matter of law and that the jury verdict should stand:

> [I]t is clear that neither the cashier nor either of the two directors ever discovered any loss within the meaning of the bond. . . . *They believed the matter to be an irregularity, but not a dishonest act.* They had implicit faith in Mr. Mauldin, the president of the bank, and at no times does it appear that any one of them felt that he had discovered a loss to the bank. To hold that the cashier and these two directors became duty bound to give notice to the surety company that they had discovered a loss under the terms of the bond would be to require them to give notice of something they neither knew nor believed. (154 S.C. at 297, 151 S.E. at 589.) (Emphasis added and deleted.)

The standards adopted by the South Carolina Supreme Court are easily seen to be substantially different from those applied by the courts below in setting aside the jury verdict in the present case.[3]

The South Carolina authorities thus stand in stark contrast to the "rules of law" at the heart of the decisions below, and yet they are not followed or even mentioned in those decisions. Both *Buddin v. Nationwide* and *Peurifoy v. Loyal* were cited and discussed in petitioner's Brief in the Court of Appeals, together with a number of other South Carolina authorities. As noted above, Judge Hoffman refers in his dissenting opinion to the fact that the case is governed by South Carolina law. He cites and discusses *Peurifoy v. Loyal* in support of his statement that he cannot believe "that the South Carolina Supreme Court, if met with a factually identical

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[3]South Carolina law is consistent with authorities, both federal and state, throughout the country on this issue. Judge Hoffman reviews a number of authorities in his opinion (Appendix B, pp. A-44 through A-55) and notes that they are "only a sample of the many cases which could be cited" (Appendix B, p. A-48). By contrast, the Court of Appeals majority curiously select as their sole authority an Ohio District Court opinion (*City Loan and Savings Co. v. Employers Liability Assurance Corp.*, 249 F.Supp. 633 (N.D. Ohio 1964)) which is correctly described by Judge Hoffman as "factually inapposite" (Appendix B, p. A-49). The *City Loan* case was, in fact, tried by the court without a jury and did not even involve the determination of whether questions should be decided by the court or the jury.

problem, would hold that [the employee's] initial acts constituted dishonesty as a matter of law." (Appendix B, p. A-53.) The failure to consider South Carolina law was made a principal basis for petitioner's Petition for Rehearing (Appendix C, p. A-63), which was denied by the Court of Appeals without opinion (with Judge Hoffman dissenting) (Appendix D, p. A-73).

The present case involves at least $1.25 million, occupied well in excess of a full week of trial time, was treated in a lengthy and detailed Order by the District Court, and elicited a strong, thorough dissent by Judge Walter E. Hoffman, sitting by designation on the Fourth Circuit Court of Appeals. The disposition by the court below involves the setting aside of a jury verdict on the basis of certain crucial "rules of law." It is inconceivable that a case of this importance could be decided without any discussion whatsoever of the controlling state law by either the District Court or the Fourth Circuit majority, especially when that state law is clearly contrary to the legal principles relied upon by those Courts. Petitioner suggests that the case thus warrants the granting of a writ of certiorari by this Court.

III. THE ACTION OF THE COURT BELOW CONSTITUTED AN INVASION OF THE PROVINCE OF THE JURY CONTRARY TO THE SEVENTH AMENDMENT TO THE UNITED STATES CONSTITUTION.

Petitioner does not suggest that every act by a trial judge of withdrawing a case from the jury violates the Seventh Amendment. However, there can be no question but that the Seventh Amendment raises the right of a party to have true factual issues determined by the jury to a level of special importance which will be carefully safeguarded by the federal courts. "The right of jury trial in civil cases at common law is a basic and fundamental feature of our system of federal jurisprudence which is protected by the Seventh Amendment" and "should be jealously guarded by the courts." *Jacob v. City of New York*, 315 U.S. 752, 752-53, 62 S.Ct. 854, 86 L.Ed. 1166 (1942) (reversing a directed verdict for defendant

in a Jones Act case because the evidence created jury issues). "The federal policy favoring jury trials is of historic and continuing strength." *Simler v. Conner*, 372 U.S. 221, 222, 83 S.Ct. 609, 610, 9 L.Ed.2d 691 (1963). "Maintenance of the jury as a fact-finding body is of such importance and occupies so firm a place in our history and jurisprudence that any seeming curtailment of the right to a jury trial should be scrutinized with the utmost care." *Dimick v. Schiedt*, 293 U.S. 474, 486, 55 S.Ct. 296, 301, 79 L.Ed. 603 (1935).

In *Byrd v. Blue Ridge Rural Electric Cooperative*, 356 U.S. 525, 78 S.Ct. 893, 2 L.Ed.2d 953 (1958) (another case arising from the District Court of South Carolina), this Court granted certiorari and held that the federal courts in a diversity action should not follow a South Carolina rule providing for the decision of a certain factual issue by the court rather than the jury, where the rule was found not to be an integral part of the definition of the rights and obligations of the parties. This Court pointed out that the Seventh Amendment "assigns the decisions of disputed questions of fact to the jury," thus establishing a "federal policy favoring jury decisions of disputed fact questions." 356 U.S. at 537-38, 78 S.Ct. at 901. The present case presents a substantially stronger position for petitioner than did *Byrd v. Blue Ridge*, in that the South Carolina law would clearly assign the decision of the issues in this case to the jury, and yet the federal District Court has taken the decision from the jury as a matter of law without so much as a mention of the applicable South Carolina substantive law.[4] If the "federal policy favoring jury decisions of disputed fact questions" as defined in *Byrd v. Blue Ridge* is to have meaningful application, it certainly precludes a federal judge from removing factual issues from the province of the jury on the basis of legal rulings which

[4]Petitioner acknowledges those decisions of this Court which hold that whether a right to a jury trial originally exists in a given case, such as whether the action is legal or equitable in nature, is a matter of federal law even in a diversity case. *E.g., Simler v. Conner*, 372 U.S. 221, 222, 83 S.Ct. 609, 610 (1963). However, that is not the basis upon which the lower courts set aside the jury verdict in the present case.

are in direct contravention of controlling state law, without even referring to that state law.

Petitioner's claim under the fidelity bonds in question is based upon losses occasioned as a result of the dishonesty of an employee (Barksdale) in failing to procure letters of credit required in connection with a number of HUD multi-family loans, and in falsely representing to petitioner and falsely certifying to HUD that such letters of credit had been procured. The jury verdict in favor of petitioner determined that its case in chief was established, and no issue is involved concerning that aspect of the case. The primary defense of the sureties INA and Hartford was that there was no coverage under the surety bonds because petitioner had knowledge of prior dishonesty on the part of Barksdale. The alleged dishonesty consisted of incorrect certifications to HUD concerning the dates of advances under the loans. The facts concerning these loan advances are, literally, unquestioned in the record and have not been challenged either by the District Court or by the Court of Appeals. Additionally, of course, the jury decision in petitioner's favor further mandates the acceptance of these facts, together with all inferences favorable to petitioner which may be drawn from them. The facts concerning the loan advances are as follows:

> Barksdale did not conceal his conduct with regard to loan advances, including their certification, from his superiors.[5] Instead, he consistently explained that HUD was aware of the manner in which he was handling loan advances and that HUD did not disapprove of this practice. A HUD handbook, quoted by Judge Hoffman (Appendix B, p. A-37, fn 2), supports Barksdale's belief by expressly recognizing that loan figures would sometimes be at variance because of advances made prior to HUD approval. Although HUD and federal prosecutors had all the information, Barksdale was never indicted in connection with his certification of loan advances (while he was indicted and pled guilty in connection with false certifications concerning the letters of credit). (Appendix A, p. A-17.) Barksdale was the only employee of petitioner familiar with HUD requirements concerning the loans in question. (Appendix A, p. A-6.) *All officers of petitioner believed Barksdale's explanations and none of them considered Barksdale's conduct with regard to loan advances or their certification to be dishonest conduct.* (Appendix A, p. A-17; Appendix B, p. A-39 (opinion of Judge Hoffman).)

[5]He did, however, lie to his superiors concerning the letters of credit. In 1973, in answer to a specific question by a superior, he represented that the letters of credit were kept in the office safe, which was an outright lie. See the Order of the District Court (Appendix A, p. A-10).

The testimony, actions and documentary evidence are absolutely unquestioned with regard to these facts. In this state of the record, two specific questions were concisely put to the jury by the district judge:

> (1) Whether Barksdale's actions with respect to the loan advances were dishonest; and
>
> (2) "Should a reasonable employer, under the same circumstances and with the same facts and at the same time, have realized that such certifications of pre-advances and over advances were dishonest and fraudulent?" (Appendix A, p. A-21.)

A response favorable to petitioner on either or both of these questions mandates the entry of judgment in favor of petitioner. The general jury verdict in favor of petitioner requires that, on review, both questions be considered as having been factually resolved by the jury favorably to petitioner. Both questions are obviously factual issues properly submitted to the jury. Under the facts of the case, there is overwhelming support for the jury verdict on both issues. The Seventh Amendment "requires that the jury be allowed to make reasonable inferences from facts proven in evidence having a reason-

able tendency to sustain them." *Galloway v. United States*, 319 U.S. 372, 396, 63 S.Ct. 1077, 1090, 87 L.Ed. 1458 (1943). The action of the District Court and the Court of Appeals in disregarding the jury verdict on these issues completely ignores the controlling South Carolina law and thereby violates the Seventh Amendment "federal policy favoring jury decisions of disputed fact questions." *Byrd v. Blue Ridge, supra.*

The jury verdict provides the appropriate basis for the complete resolution of this case. This Court has previously granted certiorari and reinstated jury verdicts on factual issues without the necessity for hearing, e.g., *Smalls v. Atlantic Coast Line R. Co.*, 348 U.S. 946, 75 S.Ct. 439, 99 L.Ed. 740 (1955),[6] and petitioner suggests that would be an appropriate remedy in the present case. 28 U.S.C. § 2106.

CONCLUSION

For the foregoing reasons, petitioner respectfully submits that this Court should grant the petition for a writ of certiorari. Petitioner further suggests that this case would be an appropriate one for reinstatement of the jury verdict by reversing the court below without further hearing, if the Court should be so inclined.

Respectfully Submitted,
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[6]Judge Hoffman also participated by designation some twenty-five years ago in the Fourth Circuit decision of *Smalls v. Atlantic Coast Line R. Co.*, 216 F.2d 842 (4th Cir. 1954), wherein the jury verdict which the Fourth Circuit had reversed was summarily reinstated by this Court upon the granting of the writ of certiorari, as noted above. Judge Hoffman's thorough and extensive dissent in the present case may reflect his experience in cases of this nature.

APPENDICES

APPENDIX A

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF SOUTH CAROLINA
GREENVILLE DIVISION

C. Douglas Wilson & Co.,
a South Carolina Corporation,

Plaintiff,

vs.

Insurance Company of North America, Philadelphia, Pennsylvania, Hartford Accident and Indemnity Company, Hartford, Connecticut, and St. Paul Fire and Marine Insurance Company, St. Paul, Minnesota,

Defendants.

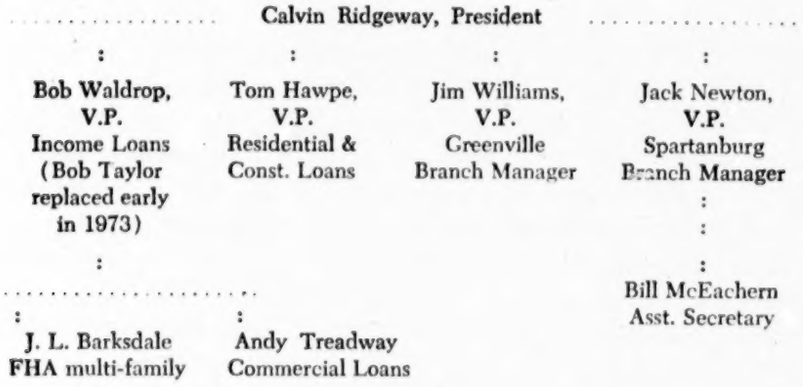
ORDER
FILED JULY 8, 1977
Civil Action No. 75-1226

This action was brought to establish the defendants' liability on fidelity bonds issued by them to the plaintiff. After incurring a loss because of dishonest conduct by one of its employees, plaintiff submitted a proof of loss to each defendant. All of the defendants denied coverage and plaintiff then filed this action seeking a declaratory judgment as to which bonds, if any, provided coverage for the loss. The case was tried before the Court and a jury and resulted in a verdict for the plaintiff. The matter is now before this Court on motion of the defendants Insurance Company of North America and Hartford Accident & Indemnity for a judgment nov or alternatively for a new trial.

The plaintiff, C. Douglas Wilson & Co. (CDW), is a mortgage broker with its main office located in Greenville, South Carolina. It was founded in 1928 by Mr. C. Douglas Wilson and has since grown to become one of the largest, if not the largest, mortgage broker in South Carolina. Since C. Douglas Wilson had a number of employees both in its main office in Greenville and in branch offices in other South Carolina cities, it was exposed to potential losses in the event one or more of its employees engaged in dishonest or criminal conduct which caused financial loss. CDW attempted to protect itself from such a contingency by purchasing a "Mortgage Banker's Blanket Bond" from defendant St. Paul Fire and Marine Insurance Co. on March 25, 1971. Under the terms of this bond St. Paul agreed "to indemnify the Insured (CDW) against any loss through any dishonest, fraudulent or criminal act of any of its employees, committed anywhere and whether committed alone or in collusion with others." This bond was a "discovery" bond in that it covered losses "sustained by the insured at any time but discovered after noon of the 25th day of March, 1971, and prior to the termination or cancellation of this bond . . . ." Thus a loss resulting from a dishonest or criminal act on the part of a CDW employee would be covered under the St. Paul bond regardless of the time at which the dishonest act was committed so long as CDW "discovered" a loss resulting from

that act within the bond period. This bond had a $500 deductible and limits of $1,000,000.

In 1970 CDW entered into merger discussions with NCNB Corp. and these discussions eventually resulted in a merger agreement which was reached in August of 1971. A year later, the merger (actually an acquisition of stock) was accomplished and CDW became a wholly-owned subsidiary of NCNB Corp. An introduction of the men who played roles in the events leading up to this lawsuit is appropriate at this point. After the merger, Robert Cashion, who headed NCNB Corp.'s mortgage banking subsidiaries, became chairman of the board of CDW. The remainder of the board was composed of Calvin Ridgeway, who was also president of CDW; C. Douglas Wilson and his nephew Sidney Wilson; and three other men who were connected with NCNB Corp. The Chairman of the Board of NCNB Corp., Mr. Addison Reese, also participated in the events which resulted in this suit. An organizational chart of CDW showing the officers who served under Calvin Ridgeway is as follows:


Calvin Ridgeway, President
Bob Waldrop, V.P. Income Loans (Bob Taylor replaced early in 1973)
Tom Hawpe, V.P. Residential & Const. Loans
Jim Williams, V.P. Greenville Branch Manager
Jack Newton, V.P. Spartanburg Branch Manager
Bill McEachern Asst. Secretary
J. L. Barksdale FHA multi-family
Andy Treadway Commercial Loans

Prior to the merger, Robert Cashion discussed insurance coverage for CDW with Calvin Ridgeway and C. Douglas Wilson and a decision was reached for CDW to continue its

existing coverage with St. Paul until the bond expired on March 25, 1973, and then to convert to coverage under NCNB Corp.'s blanket bonds which had been issued by INA and Hartford. In January and February of 1973 Cashion was aware that the coverage changes were coming up on March 25.

NCNB Corp. and its subsidiaries were insured against losses from employee dishonesty by bonds issued by INA and Hartford. On March 25, 1973, CDW also became an insured under these bonds. The INA bond is entitled "Banker's Blanket Bond." This bond is very similar to the St. Paul bond because it covers "[l]oss through any dishonest or fraudulent act of any of the Employees, committed anywhere and whether committed alone or in collusion with others." Also, like St. Paul's, INA's bond is a discovery bond which covers losses "sustained by the insured at any time but discovered during the bond period." The limits of the INA bond are $8,000,000 and the bond has a $50,000 deductible. Because of the large deductible provision in the INA bond, the Hartford bond was purchased to fill the gap for NCNB Corp.'s mortgage banking subsidiaries. It had limits of $50,000 and a $1,000 deductible. By its terms, the Hartford bond covered any "loss sustained by the insured (CDW) through fraudulent or dishonest acts committed during the bond period by any Employee . . . ." Unlike the St. Paul and INA bonds, the Hartford bond is a "loss sustained bond" rather than a "discovery" bond. The loss sustained must result from an act of dishonesty committed during the bond period. The discovery of the loss does not have to occur during the bond period but must occur within at least one year from the end of the bond period. Despite the fact that the Hartford bond was written on a loss sustained basis, at the trial it was treated as a discovery bond because of its "substitute" provision. The issue concerning the effect of this provision will not be reached due to the disposition reached below.

Sometime during the spring of 1973 CDW discovered that it was likely to sustain a substantial loss because of allegedly dishonest conduct by J. L. Barksdale, the employee in the income loan division who was responsible for all FHA-HUD multifamily loans. By way of background, in the late 1960's the Federal Housing Administration, a division of HUD, began to emphasize the construction of apartment complexes for low income families by offering to insure the mortgage loans on the property. The construction of one of these projects would be initiated by a "sponsor" who was a person or corporation interested in investing in a low income housing project. This sponsor would approach FHA to determine whether FHA saw a need for a multifamily housing project in a certain area. FHA would study the sponsor's proposal and if it determined that the proposed project was desirable it would so inform the sponsor by writing a feasibility letter informing him that the proposed project at the proposed location was approved by FHA. The sponsor would then apply to FHA for a conditional commitment and would furnish to FHA the preliminary architect's drawings and preliminary engineering reports so that FHA would have a better concept of exactly what type of project was proposed. If FHA was satisfied with the nature of the project as proposed, it would issue a conditional commitment which would mean that if everything was accomplished in the proper fashion, FHA would issue a definite commitment to insure the repayment of the mortgage loan.

The sponsor would then approach a mortgage banker, such as CDW, to obtain a commitment for the loan. Then the final architectural and engineering drawings would be prepared and submitted to the FHA which would issue a firm commitment. At this point, a meeting would be held for the "initial closing" of the loan. Present at this meeting would be the sponsor, his attorney, the mortgagee (CDW), the architect, FHA officials, and perhaps others.

After the initial closing, construction on the project would begin and the sponsor would make periodic, usually

monthly, requests to the mortgagee for advances, or construction draws. These advances were required by the sponsor so that he could make monthly payments for labor and materials. After completion of construction, an application would be made to FHA for an "endorsement" of the loan which was essentially FHA's final commitment to insure the permanent loan.

As a condition for insuring the mortgage loans on these low-income projects, FHA required that the sponsor make certain deposits to insure that he was financially able to complete the project and to cover certain contingencies. These deposits were required to be either in cash or represented by an irrevocable letter of credit. One of these deposits was referred to as the "working capital deposit," and its purpose was to assure the availability of funds to pay certain fees to FHA or HUD, real estate taxes on the project, insurance premiums for fires and other perils, and routine expenses associated with opening the project for occupancy.

Another deposit was required to insure the availability of funds to meet anticipated operating deficits during the rent-up period after completion. A deposit was also required to assure completion of the project in view of the fact that the loan insured did not represent 100% of the cost of the project. Because the project was known to cost more than the amount loaned by the mortgagee, FHA wanted to make sure that the sponsor was financially able to produce the additional funds needed to complete the project.

One additional deposit was required to assure that the sponsor could pay certain fees and discounts to the permanent lender. These costs resulted from the fact that a construction mortgagee, such as CDW, did not remain mortgagee after completion. CDW was not in the business of investing in long term obligations, therefore, after final endorsement by FHA, it would sell the loan package to an insurance company or savings and loan association. It would then receive the monthly payments on the loan or "service" the mortgage loan for a certain fee. Since FHA regulations prevented the permanent lender from charging as high an

interest rate as it customarily received, the permanent lender would make up the difference by requiring the sponsor to pay certain fees and discounts up-front. The last deposit was required by FHA to assure the sponsor's ability to pay these fees and thus obtain the permanent loan.

Prior to the time that CDW became involved with FHA multi-family loans it had been extensively involved with FHA single-family loans. Accordingly, there were a number of CDW employees who were familiar with FHA loans in the single-family area. When CDW decided to become involved with FHA multi-family loans, it needed to assign someone the responsibility for operating this segment of CDW's business. Since there were no CDW executives, who were familiar with FHA multi-family loans, James L. Barksdale was requested to familiarize himself with the regulations, forms and procedures in connection with these loans and he was placed in charge of this division. Barksdale had started to work for CDW in 1962 and had been assigned to help Robert Waldrop with conventional income producing loans. When Barksdale was placed in charge of FHA multi-family loans, he was still a subordinate of Waldrop; however, Barksdale was the only person in the CDW organization who had any appreciable knowledge about FHA multi-family loans. If someone else in the organization had some question about procedures followed in a multi-family loan, he would ask Barksdale.

As previously discussed, in an FHA multi-family project a number of steps were involved between the sponsor's proposal and FHA's final endorsement. Many of these steps involved the completion and execution of FHA forms. One of these forms was entitled "Commitment for Insurance of Advances." This form was prepared by the FHA and was issued to both the mortgagee and the sponsor before initial closing of the loan. By the terms of the commitment, FHA stated its intent to insure the mortgage "subject to compliance with the requirements of the Regulations, and the terms and conditions set forth" in the commitment form.

One of the terms in that form provides:

> Approval of advances in accordance with the Building Loan Agreement must be obtained on a form prescribed by the Commissioner prior to the date of each advance to be insured.

The relevance of this term will be demonstrated later. At the initial closing, CDW would execute a form entitled "Mortgagee's Certificate." On this form, CDW would certify that it had obtained the various deposits referred to previously. These forms almost always indicated that the deposit received by CDW was in the form of a letter of credit. By completing and signing this form, CDW would also certify that it would not "make any loans or advances to the mortgagor, any of the sponsors, the general contractor, or the architect for any purpose connected directly or indirectly with this project without prior written approval of the Commissioner."

During the course of construction on the project, another FHA form was involved in connection with each advance. The back side of this form (FHA 2403) was entitled "Request for Payment." This form was filled out by the mortgagor and submitted to CDW and requested a construction advance of a specified sum. The costs to be paid with the requested advance were itemized and the architect signed the form at the bottom certifying that he had visited the project and that the work for which payment was requested had been completed in accordance with the contract drawings. After receiving this document from the mortgagor, CDW would complete and sign the top half of the form on the front side. This section of the form was entitled "Application for Insurance of Advance of Mortgage Proceeds." On this form, CDW requested FHA approval of the advance and stated its intention to disburse the requested funds on a specified date provided it received prior approval from FHA. The form would then be sent to FHA which would complete the bottom half of the front side en-

titled "Certificate of Mortgage Insurance". By executing this form, the FHA notified CDW that a specified amount was approved for advance and that the funds advanced would be insured by the FHA.

The final form in this procedure was entitled "Request for Final Endorsement of Credit Instrument." By executing this form, CDW was seeking FHA's final assurance that the loan to the mortgagor was completely covered by FHA insurance so that the permanent loan package could be sold. To complete this form CDW would prepare a schedule of advances listing the date of each advance and the amount thereof. By signing the form, CDW "declare[d] . . . that advances have been made . . . on the dates and in the amounts set forth in the schedule . . . ." The reverse side of this form also contained two sections entitled Certificate of Mortgagor and Certificate of General Contractor. The mortgagor would certify that it had received the amount of the loan insured by the FHA and the contractor would certify as to the completion of construction and payment of all obligations under the construction contract. The very bottom of this form contained the following warning:

> U. S. Criminal Code, Section 1010, Title 18, U.S.C., "Federal Housing Administration Transactions", provides in part: "Whoever for the purpose of . . . influencing in any way the action of such Administration . . . makes, passes, utters, or publishes any statement, knowing the same to be false, . . . shall be fined not more than $5,000 or imprisoned not more than two years, or both."

All of these forms which were submitted to the FHA by CDW were required to be signed by some CDW official. Although J. L. Barksdale was completely in charge of the FHA multi-family division of CDW, he frequently directed other CDW officials to sign these forms on his assurance that they were in order and in accordance with FHA regulations. Accordingly, although a number of these forms were signed by Barksdale, some of the forms contained the signatures of Andrew Treadway, Assistant Vice-President in charge of commercial loans, and William McEachern, Assistant Secretary to the Manager of the Spartanburg branch.

The branch offices of CDW handled loans on single family residences, both conventional and FHA insured. All of the income loans were handled through the home office in Greenville. However, there was one exception in that the Spartanburg branch handled some FHA multi-family loans. The reason for this was that one of CDW's best customers in the Spartanburg branch, real estate developer Gene Phillips, became interested in investing in low income multi-family projects insured by the FHA. Phillips dealt primarily with William McEachern, the assistant manager of the Spartanburg branch, and McEachern, not being familiar with FHA multi-family loans, relayed Phillips' inquiries to Barksdale in Greenville. As it turned out, Phillips invested heavily in FHA multi-family projects and the FHA insured construction loans on his projects were handled through the Spartanburg office. Although McEachern signed many of the FHA forms on the Phillips' projects, it appears that his duties were merely clerical. He signed the FHA documents at Barksdale's direction on the assurance that everything was in order. Barksdale had the sole responsibility for obtaining the letters of credit or cash deposits required by FHA for all multi-family loans whether they were handled through the Greenville or Spartanburg offices.

With this background, the series of events leading up to this lawsuit can now be discussed. In February of 1973, CDW's senior vice president in charge of the income loan division, Robert Waldrop, retired and was replaced by Robert Taylor. After beginning his work at CDW, Taylor learned that the FHA multi-family loans fell into his division and that J. L. Barksdale was in charge of these loans and was CDW's expert on the procedures and regulations which applied to these multi-family loans. In early March, Taylor learned that the FHA multi-family loans constituted a substantial proportion of CDW's business. Accordingly, in order to familiarize himself with this aspect of the business,

and because as the vice president in charge of income loans he was responsible for those FHA loans, Taylor asked Barksdale to explain the procedures followed in these loans. Barksdale and Taylor got together and went over a number of the files on the FHA loans. Taylor was shown the various documents required by the FHA, one of which was the Mortgagee Certificate. After Barksdale had explained the deposits which were required by the Mortgagee Certificate, Taylor asked where the letters of credit representing these deposits were kept. Barksdale replied that he kept them in the office safe.

Also in early March, specifically on March 2, a Mr. Robert Shaw accompanied Cashion on a visit to CDW's Greenville office to meet the key men in the organization. Shaw was a vice president of CDW's parent, NCNB Corp., and had the title of "credit review officer". He was an internal auditor with the responsibility of reviewing the loan portfolios of NCNB Corp's subsidiaries. Shaw was a subordinate of Addison Reese, who at that time was chairman of the board of NCNB Corp. After conducting a credit review of one of the subsidiaries, Shaw would report his findings to Reese and to the head of the subsidiary whose loan situation he was reviewing. Shaw's visit to CDW on March 2 was the preliminary step of a credit review of CDW which had been requested by Reese. Shaw was in Greenville for only half a day on the 2nd and, in addition to meeting the CDW officers, only had time to review a few of the loans on single family residences. He returned to Greenville on Friday, March 16, to continue familiarizing himself with CDW procedures in preparation for a full scale review. This time he concentrated on income loans and reviewed some representative files on which a report had been prepared by CDW personnel. Shaw was familiar with FHA multi-family loans through his knowledge of the credit extended by NCNB Mortgage Corp., another wholly owned subsidiary of NCNB Corp. However, when he reviewed the FHA files at CDW, he noticed that the files were much different and

he experienced some difficulty in analyzing the credit which had been extended. One of the problems he encountered was reconciling the advances shown on the Request for Final Endorsement with the advances indicated by the bookkeeper's ledger records. Shaw felt that some other document might explain the apparent inconsistency so he selected a file on a project known as Keoway Apartments and made a photocopy of the schedule of advances shown on the Request for Final Endorsement and of the advances shown by the ledger. He took these copies to Barksdale and asked whether the information shown was correct or whether he was reading the documents incorrectly. Barksdale told him that the figures shown on the ledger were correct but that the information shown on the Request for Final Endorsement was not. He explained that the discrepancy resulted from the fact that CDW frequently made construction advances, prior to receiving approval for the advance from FHA, and the figures on the Request for Final Endorsement were wrong because they reflected that all advances had been made in accordance with FHA approval. These figures were apparently manipulated so that all FHA forms would be in proper order. When Shaw inquired as to the reason for making these "pre-advances" Barksdale explained that CDW did this to accommodate the sponsor, who was experiencing difficulty, because of the delay between his request for payment and the actual advance. It appears that it sometimes took three to four weeks for a request for payment to be approved by FHA during which time the sponsor's laborers and suppliers were pressuring him for payment for the services or goods which had been supplied. Shaw asked Barksdale whether this practice of advancing prior to receipt of approval was sanctioned by FHA and Barksdale replied that FHA was aware of the practice and knew that the information contained on the schedule of advances was not correct. In light of this explanation, Shaw continued his review of the five representative files selected by CDW. After finishing his review, Shaw went to meet with Ridge-

way but found that he had left the office for the day. However, Ridgeway's secretary said that he would be in Charlotte on Monday to meet with Cashion and Shaw could see him then. Shaw then drove back to his home in Charlotte and over the weekend prepared a memorandum to Ridgeway revealing his discoveries concerning the preadvance situation. This memo was typed at the office on Monday morning, the 19th, and copies were prepared for Messers Reese and Cashion. This memo of March 19 reads as follows:

Keoway Apartments

This past Friday I visited with Tom Hawpe and Jim Wall to review several of your commercial loan credit files to become familiar with your procedures and records in connection with my initial credit review of C. Douglas Wilson & Co. in the near future. In reviewing this FHA insured advances project, several items were noted which I would like to bring to your attention.

On several occasions, construction loan advances have been made before FHA approval has been received, with some advances being greater than the amount subsequently approved by the FHA. We have been advancing what the developer may request while the FHA might approve a smaller sum. On March 1, 1973, C. Douglas Wilson & Co. submitted a "Request For Final Endorsement of Credit Instrument" to the FHA in which the date and amount of each advance and total advances of $818,-292.16 were certified. A number of the dates and amounts were not correctly given and the total actually advanced is $898,292.16, with the extra representing three advances in August, September, and November, 1972, without FHA approval. Total outstanding is 99.5% of the note face amount of $902,900.

First Federal Savings and Loan of Greenville provided the permanent loan take out and also bought 100% of the construction loan. As noted above, they have bought $80,000 above the amount approved by the FHA. This apartment project was expected to be completed by March 1, 1972, and purchased then by First Federal; however, weather delayed construction, the completed project is having occupancy problems, and the project purchaser has inadequate funds to carry the project. First Federal has extended its take out on several occasions and I understand it now expires March 31, 1973, however, I was unable to find a copy of this current extension. Interest has not been paid on the loan since May, 1972. I was unable to find builders risk insurance coverage with appropriate loss payable.

Wooten Construction Company, the developer and contractor, and Mr. Ward Stone have been long and valued customers of C. Douglas Wilson & Co.

During the course of my visit Friday, I reviewed several other commercial credit files and commitments and it appears that similar situations exist with other credits. It looks like we have advanced more than our note and mortgage on Cherry Mobile Home Park.

Ridgeway and Cashion were in conference in the office in Charlotte and Shaw had the memo delivered to them during a break. After they had had a chance to read the memo, Shaw, Ridgeway and Cashion met to discuss Shaw's findings as revealed therein. A detailed discussion was held with both Ridgeway and Cashion expressing some concern about the pre-advance situation despite Shaw's description of Barksdale's justification for the practice. Most of this concern centered on the exposure that CDW had on advances made beyond the amounts approved by FHA because such excess amounts would be uninsured. The decision was then made

that Ridgeway would return to Greenville and have CDW personnel review all FHA loans to determine the extent of CDW's exposure as a result of these pre-advances (sometimes called "over advances"). Shaw visited the Greenville office again on April 16 or 17 and discovered that no work had been done on determining the amount of the over-advances on the FHA loans. He then reviewed all FHA files himself and determined that over advances, that is advances made by CDW without HUD approval and without insurance, totaled more than $575,000. Shaw then met with Ridgeway on the 18th and revealed his findings.

Later in April, an unrelated series of events of particular importance unfolded. William McEachern was in Gaffney making his regular call on Phillips and Phillips expressed an urgent desire to meet with McEachern and Jack Newton. Newton was tied up with other matters and tried to postpone such a meeting, but, because of Phillips' urging, met with him and McEachern at eight-thirty or nine o'clock that night. At that meeting Phillips revealed that he was experiencing rather severe financial difficulties and wanted a working capital loan from CDW in the neighborhood of $1,000,000. In light of this request a meeting with Robert Taylor and Tom Hawpe was scheduled in the Greenville office the next day. Present at this meeting were Taylor, Hawpe, Newton, McEachern and Phillips. After discussion of Phillips' request, which centered mainly on CDW's reasons why such a loan could not be made, Phillips said CDW might as well make the loan, because if he went under, the letters of credit would have to be called on and many of these letters of credit were issued by the North Carolina National Bank, another subsidiary of NCNB Corp. This statement came as a shock to the CDW personnel and they decided to determine how many letters of credit had been issued by NCNB. McEachern offered to find out how many letters of credit had been issued by NCNB and he went into Barksdale's office and asked him who had issued the letters of credit on Phillips' FHA project. Barksdale then said something to the effect

that he could take the pressure from the over advances but not from the letters of credit and admitted to McEachern that he had not obtained any of the letters of credit. McEachern then went back to the meeting and repeated what Barksdale had told him. In light of this information, Taylor also went to see Barksdale to inquire about the letters of credit and Barksdale also told him that he didn't have them, neither on the Phillips loans nor on the rest of the projects. The next day, the CDW officers at the meeting went to Charlotte and discussed the situation with Cashion and a decision was made to loan Phillips $1,200,000. At this meeting, Cashion and Taylor also decided to fire Barksdale. Taylor called Barksdale from Charlotte and asked him to stay at the office until he got there. Taylor and Ridgeway then met with Barksdale at six o'clock that day and presented him a letter of resignation which he signed. Barksdale then cleared out his personal belongings and left that night.

Immediately after the discovery of these missing letters of credit, NCNB Corp. sent an internal auditing team to Greenville to determine CDW's exposure as a result of the missing letters of credit. This exposure resulted from the fact that, since CDW had certified to FHA that it had obtained the letters of credit, CDW, in the event of a default situation which necessitated calling on the letters of credit, had to stand behind them. The internal audit to determine the potential loss to CDW resulting from the missing letters of credit was conducted primarily by Robert Shaw. By May 10, he had determined that CDW could possibly lose as much as $3,000,000 because of Barksdale's failure to obtain the letters of credit he had certified existed on the Mortgagee Certificate. The three insurance companies were then notified of a potential claim arising out of this financial loss caused by Barksdale. After determining that the loss potential approached $3,000,000, CDW personnel took steps to mitigate any losses arising from the absence of the letters of credit by seeing that some of the projects were completed despite the sponsor's insolvency, or by foreclosure or by any other

means which would possibly eliminate the necessity for calling on the letters of credit. These mitigation efforts were successful to some degree and CDW now claims losses as a result of the missing letters of credit of approximately $1,250,000. After all the insurance companies denied coverage for this loss, CDW instituted this lawsuit. Since the exact amount of the loss was not precisely known at the time the suit was filed and since CDW is continuing its efforts to mitigate its losses, the complaint did not ask for monetary damages but rather sought a declaratory judgment as to the liability of each company on its bond. In this suit, plaintiff was only claiming a covered loss as a result of the missing letters of credit. No claim was made because of the over advances because plaintiff claimed that it sustained no loss as a result of this practice.

At the trial, plaintiff presented evidence to prove its position that Barksdale's conduct of certifying on the Mortgagee Certificate that CDW had obtained the required letters of credit, when in fact these letters of credit had not been obtained, constituted dishonest conduct for which the defendants' bonds afforded coverage. Plaintiff proceeded primarily against INA and Hartford because it took the position that the loss was discovered after March 25, 1973, the effective date of each bond. St. Paul was named as a defendant so that if the discovery date was determined to be prior to March 25, CDW would be entitled to recover from St. Paul on its fidelity bond. Plaintiff asserted that the loss was discovered on May 10, the date that the full extent of the loss became known. In any event, plaintiff's attorneys claimed that the loss was not discovered prior to April 26, the date on which the letters of credit were discovered to be missing.

Defendants INA and Hartford defended primarily on the theory that CDW had knowledge prior to March 25 that Barksdale had committed a dishonest act in connection with the over advances. According to them, this knowledge, since it was not communicated to the companies, voided the bonds coverage as to Barksdale. Defendant St. Paul took the position that no one at CDW discovered dishonest conduct which resulted in a loss prior to March 25 so as to cause its bond to afford coverage.

Plaintiff supported its claim by showing that the bonds had been issued, that the premium had been paid and that it had sustained a loss. It reinforced its argument that the certification with respect to the letters of credit was a dishonest act by introducing a guilty plea of J. L. Barksdale to an indictment charging him with three counts of violating 18 U.S.C. §1010. This section of the Code makes it illegal to submit false information to the Department of Housing and Urban Development with the intent of influencing the actions of that department.

Plaintiff also addressed itself during its case in chief to the defense of INA and Hartford that CDW discovered dishonest acts by Barksdale prior to March 25. Plaintiff attempted to distinguish between Barksdale's conduct with regard to the letters of credit and his conduct with regard to the over advances. Witnesses for the plaintiff testified that, even after receipt of Shaw's March 19 memo, no one at CDW, except possibly Barksdale, knew that advancing construction money prior to receipt of FHA approval was a violation of FHA policy and regulations. All of the participants in this series of events asserted that they considered the over advances to be a poor business practice but they did not consider it to be dishonest conduct. Plaintiff pointed to the fact that the situation involving the letters of credit was different from that involving the over-advances. Barksdale was fired almost immediately after the letters of credit were discovered to be missing; however, no action, not even a reprimand was taken against Barksdale after the March 19 memo revealed the over-advance situation. Furthermore, Barksdale was only convicted of submitting false forms to FHA in connection with the letters of credit. He was not convicted of, nor was there even an investigation into an indictment arising from, false certifications made by Barksdale concerning the advances.

Plaintiff also pointed out that the practice of over advancing did not subject CDW to the same risk of loss as did the failure to obtain the letters of credit. The reason for this was that there was only a short time lapse during which the construction advance would be uninsured. This was so because, even though an advance was made prior to receipt of FHA approval and thus without insurance, the approval would be forthcoming and the money advanced would soon be insured.

With regard to the Mortgagee Certificate, the form which Barksdale was convicted of falsifying, plaintiff argued that the criminal and dishonest act was the certification that the letters of credit had been obtained when they had not. Although Barksdale, by signing that form, also certified that CDW would make no advances prior to receipt of FHA approval, plaintiff argued that this certification was not a dishonest act since it only represented an intent to perform a future act.

Plaintiff's response to the defense of INA and Hartford was essentially that none of the actions of Barksdale in regard to the over advance situation can be considered dishonest. However, plaintiff argued, even if they were dishonest, CDW did not know prior to March 25, or have any reason to know before that date, that Barksdale had committed a dishonest act. To the contrary, all CDW officials, who knew about the practice of over advancing, considered it to be a poor business practice, but not dishonesty.

At the close of plaintiff's case, defendant St. Paul made a motion for an involuntary nonsuit on the ground that no evidence had been presented that any act of dishonesty which caused a loss to CDW had been discovered during its bond period. Although plaintiff's attorneys did not vigorously oppose this motion, the attorneys for INA and Hartford argued that St. Paul should not be released from the case because they intended to introduce evidence that the missing letters of credit were discovered prior to March 25, 1973, possibly as early as November, 1972. The Court, however, granted

St. Paul's motion despite the protests from INA and Hartford because plaintiff had failed to prove any loss for which St. Paul's bond would provide coverage. The Court was of the opinion then, and is now, that the fact that the plaintiff sought a declaratory judgment rather than damages does not extinguish its burden of proving a claim. St. Paul could not be forced to remain in the suit merely because a codefendant intended to introduce evidence which might establish St. Paul's liability.

The case presented by INA and Hartford primarily centered on their claim that CDW knew of dishonest conduct on the part of Barksdale prior to March 25. The legal basis for such a defense was twofold. First, the remaining defendants asserted that, if CDW had knowledge that Barksdale had committed a dishonest act, it had a duty imposed by the common law to disclose this fact to the defendants prior to their providing fidelity coverage for Barksdale. Second, each bond had a clause providing that it would be "cancelled as to any Employee . . . as soon as the Insured shall learn of any dishonest or fraudulent act on the part of such Employee . . . ." (INA bond §10). Accordingly, since CDW knew about Barksdale's dishonesty before the effective date of the INA and Hartford bonds, the bonds were cancelled as to him before the bonds even took effect and he was, therefore, never covered. The defendants had the burden of proving two things in order to prevail on this defense. First, they had to prove that some act of Barksdale, which was connected with the over advancing, constituted a dishonest act. Second, they had to prove that some officer or director of NCNB Corp. or CDW knew or had reason to know prior to March 25, that Barksdale had committed a dishonest act.

In arguing that Barksdale's action with regard to the over advances constituted dishonest conduct, defendants attempted to prove that no difference existed between the false certifications on the Mortgagee's Certificate regarding the letters of credit and the false certifications on the Request for Final Endorsement regarding the dates and amounts of construction

advances. Defendants elicited admissions from NCNB Corp. and CDW officers and directors, who participated in the series of events outlined, that the policy at CDW was that all FHA regulations were to be followed and that all forms submitted to FHA were to be accurate and truthful. Many, if not all, of these witnesses also admitted that they considered the false certifications on the Request for Final Endorsement regarding the advances to be a dishonest act. Some even called such conduct criminal. However, every witness, who admitted the dishonest nature of such conduct qualified this admission by asserting that, at the time when they learned about the over advances and the certifications with respect to them and in light of the circumstances existing at that time, they did not consider any conduct of Barksdale to be dishonest but rather considered it to be poor business practice.

In the course of their attempt to prove dishonesty in connection with the over advances, defendants also argued that, even though Barksdale was never indicted or convicted because of any conduct regarding the over advances, the certification of false dates and the amounts of advances on the Request for Final Endorsement was a violation of 18 U.S.C. §1010. This is the same criminal section that Barksdale violated by falsely certifying the existence of the letters of credit.

As to the knowledge aspect of their defense, defendants placed reliance on Shaw's March 19 memorandum. They asserted that Shaw discovered the dishonest acts of Barksdale on March 16 and that Reese, Cashion and Ridgeway had knowledge of Barksdale's dishonesty on March 19 after receiving that memo.

In the closing instructions to the jury the Court explained that four questions had to be answered in order to ascertain whether the defendants' bonds provided coverage. The first question was whether plaintiff had met its burden of proving that the false certifications regarding the letters of credit was a dishonest act. This question was necessary because defendants took the position that the acts of Barksdale in this connection were not "dishonest" within the meaning of

that term as used in the bonds. The jury was next asked to determine whether CDW had discovered prior to March 25 that Barksdale had failed to obtain the letters of credit. This question was asked because Barksdale's deposition was read to the jury which indicated that CDW officials knew about the missing letters of credit as early as November 1972. Defendants used this evidence to counter that of the plaintiff which showed a discovery date between April 26 and May 10, 1973.

The last two questions involved the defense of prior discovery of a dishonest act. In the third question, the jury was asked to determine whether Barksdale's actions with respect to the over advances were dishonest. If the jury determined that they were, they were asked to consider the fourth question which asked, "[S]hould a reasonable employer, under the same circumstances and with the same facts and at the same time, have realized that such certifications of pre-advances and over advances were dishonest and fraudulent." Trans. at 808.

After deliberating less than thirty minutes, the jury returned with a verdict for the plaintiff. After reviewing the evidence and the briefs in support of and in opposition to the motions, the Court is of the opinion that the verdict of the jury is against the clear weight of the evidence and should be set aside.

In reaching this conclusion, the Court has determined that the evidence is so overwhelming that it proves, as a matter of law, both that Barksdale's conduct in falsely certifying the Request for Final Endorsement was dishonest and that the management of CDW knew about this dishonesty prior to March 25.

The Court is not holding that all of Barksdale's actions regarding the over advances were dishonest as a matter of law. For example, a legitimate factual issue was presented as to whether the certifications on the Mortgagee's Certificate relating to the advances was dishonest. Plaintiff made a valid argument that the certificate on that form that CDW would

not advance prior to receipt of FHA approval was not dishonest because it related to intent to perform a future act. This same argument would apply to the "Application for Insurance of Advance of Mortgage Proceeds" in which CDW, through Barksdale, stated its intent to disburse a specified sum "provided we receive prior approval". Whether these certifications by Barksdale constituted dishonest conduct was a valid factual issue which the jury had a right to decide. The jury also had a right to determine whether Barksdale's violation of FHA regulations by advancing prior to receipt of approval constituted dishonesty on his part. A technical violation of a regulation does not, as a matter of law, constitute dishonest conduct under a fidelity bond. *See Fidelity & Deposit Co. of Maryland v. Peoples Bank of Sanford,* 72 F.2d 932 (4th Cir. 1934). However, the false certifications made by Barksdale and others at his direction on the Request for Final Endorsement cannot be considered as anything but dishonest. The form for the Keoway project, which was the subject of the March 19 memo, stated:

> The undersigned declares that construction of this project is complete, and that advances have been made to the mortgagor in accordance with your Certificate of Insurance on the dates and in the amounts set forth in the schedule below; and that to the best of the undersigned's knowledge and belief the said loan is now eligible for mortgage insurance and accordingly, the undersigned hereby requests final endorsement of the attached credit instrument for mortgage insurance . . . .

This form, which was signed for CDW by J. L. Barksdale, contained a schedule of advances in which both the dates and amounts of many of the advances were incorrectly stated and which contained a figure representing the total amount advanced which was incorrect. The evidence clearly showed that this information was incorrect because Barksdale had intentionally falsified the figures so that they would conform

with those in FHA's file and FHA would, therefore, insure the permanent loan. Barksdale falsified this form despite the warning on the back thereof that knowingly making a false statement to the FHA for the purpose of influencing in any way the action of that administration constituted a criminal act. Thus, in addition to being dishonest, the false certification of this form was criminal. There is no question that Barksdale knew the information was false and that his purpose was to influence the FHA by getting it to endorse the loan.

The determination that Barksdale's false certification of the advance schedule was dishonest as a matter of law is consistent with the legal definition of "dishonesty" as that term is used in a fidelity bond. In *City Loan & Sav. Co. v. Employer's Liability Assur. Corp., Ltd.,* 249 F.Supp. 633 (N.D. Ohio 1964), the Court stated:

> "Dishonesty", as used in a fidelity bond, is to be interpreted according to its usual and ordinary meaning. To constitute dishonesty, the conduct need not amount to a crime and need only involve bad faith or a want of integrity or untrustworthiness or a disposition to lie or cheat or a faithlessness to a trust. To constitute dishonesty, there need not be an intent to profit or to cause a monetary loss to the employer.

249 F. Supp at 656 (citations omitted). See also *Arlington Trust Co., Inc. v. Hawkeye Security Ins. Co.,* 301 F.Supp. 854 (E.D.Va. 1964); 9 *J. Appleman, Insurance Law and Practice* §5706 at 566-67 (1943). However, even if the legal definition of dishonesty did not dispositively characterize the certification of the over advances, plaintiff's position that the letter of credit certifications were dishonest would require that the certifications as to the advances also be dishonest. There can be no distinction between the false certification on the Mortgagee's Certificate and the false certification on the Request for Final Endorsement. If one is dishonest, then the other necessarily is also.

Even though Barksdale committed a dishonest act by falsely certifying the advance schedule, the defense of prior discovery does not succeed unless officers or directors of NCNB Corp. or CDW knew about these acts of dishonesty prior to March 25. There is no question that a number of individuals knew that Barksdale was advancing funds prior to receipt of FHA approval. These individuals included Waldrop, Shaw, Cashion, Reese and Ridgeway. However, this knowledge, without more, would not justify setting aside the jury's resolution of the knowledge issue. Whether or not the making of the over advances was dishonest was a question of fact for the jury. Likewise, whether the knowledge of the over advance practice constituted knowledge of dishonesty was also a question of fact.

If, on the other hand, CDW had knowledge of false certifications prior to March 25, then CDW had knowledge of dishonesty as a matter of law. This is so because "[w]here . . . one has actual knowledge of facts which without more, constitute dishonesty as a matter of law, it follows that one has actual knowledge of dishonesty as a matter of law." *City Loan & Sav. Co. v. Employers' Liability Assur. Corp., Ltd., supra* at 657. This conclusion is consistent with the test which states that one "discovers" dishonesty when he acquires "knowledge which would justify a careful and prudent man in charging another with fraud or dishonesty." *Hidden Spendor* (sic) *Mining Co. v. General Ins. Co. of America*, 370 F.2d 515, 517 (10th Cir. 1966) quoting from *American Employers' Ins. Co. v. Raton Wholesale Liquor Co.*, 123 F.2d 283, F.2d 283, 285 (sic) (10th Cir. 1941).

The evidence overwhelmingly establishes that CDW had actual knowledge of false certifications prior to March 25. Shaw clearly knew about this conduct on March 16. He discovered the false certifications and even discussed with Barksdale the Request for Final Endorsement which had been falsified. There is no question that he knew Barksdale was certifying incorrect information to FHA to cover up the advances made without FHA approval. He then relayed this

information in his March 19 memo and his discussion with Cashion and Ridgeway that same day. That memo discussed the false certification as follows:

> On March 1, 1973, C. Douglas Wilson & Co. submitted a "Request for Final Endorsement of Credit Instrument" to the FHA in which the date and amount of each advance and total advances of $818,292.16 were certified. A number of the dates and amounts were not correctly given and the total actually advanced is $898,292.16, with the extra representing three advances in August, September, and November, 1972, without FHA approval.

The memo itself would not conclusively establish that Barksdale intentionally falsified the form. However, from the testimony at trial, it appears that the recipients of that memo interpreted it in that manner. Addison Reese, Chairman of the Board of NCNB Corp., gave the following testimony in this regard:

> Q. Based on your review of Mr. Shaw's March 19 memorandum and I am referring to the one that first brought to light the question of the over advances and your subsequent discussions with him and the conference which you had on the following day and so forth, you were aware, were you not, that the over advance situation did involve a false certification being made to FHA or HUD, is that correct?
>
> A. Yes.
>
> Q. And you understood also that that false certification was made by an officer or employee of C. Douglas Wilson & Company?
>
> A. Yes.
>
> Q. At that point in time did you know whether that certification was an oral certification, a written certification or whatever?

A. Written.

Q. Again, based on these same meetings, conferences and memoranda, you are aware that a false certification had in fact been made to FHA?

A. Yes.

Transcript at 702. Robert Cashion, Chairman of the Board of CDW, also admitted to knowledge of these false certifications:

Q. "Or how would you justify that?"

A. "I can't justify it, but I can explain it. The individual doing it was apparently covering up his mistakes in having advanced money beyond the amount of certification."

Q. All right sir. So, on March 19 when you received the memorandum, you were aware that the only explanation, not justification, but explanation for that form going to the government like that was that a man was trying to cover up his mistakes?

A. Right.

Q. That man was J. L. Barksdale?

A. Right.

Q. And he was sending something to the government to cover up his prior mistakes.

A. Right.

Transcript at 344-45.

The evidence at trial also established knowledge on the part of CDW even before the March 19 memo. Robert Waldrop, Barksdale's superior and former vice president in charge of the income loan division testified as follows:

Q. Were you aware that Mr. Barksdale was making false certifications to FHA or HUD regarding these over advances?

A. I was aware that he was making applications and certifications which did not deal with what we were advancing. He told me this.

Transcript at 639-40.

Any decision by the jury that CDW did not have knowledge of dishonest conduct by Barksdale prior to March 25 is against the clear weight of the evidence. The testimony to the effect that CDW officials did not consider Barksdale's conduct to be dishonest at that time does not make discovery a factual issue. CDW had knowledge of the false certifications as a matter of law and the false certifications were dishonest as a matter of law. Accordingly, CDW is charged with knowledge of Barksdale's dishonest conduct.

The fact that Barksdale's dishonest conduct was discovered by CDW prior to March 25 requires that defendants be granted a judgment nov for two reasons. First, CDW had a duty to disclose to both INA and Hartford its knowledge that Barksdale had been falsely certifying the Request for Final Endorsement. The rule requiring such disclosure has been stated as follows:

> Any taking advantage of a surety by withholding proper information has been held to avoid the bond. And the nondisclosure of material circumstances affecting the situation of the parties which are within the knowledge of the person procuring the bond has this effect, even though not wilful or intentional or with a view to any advantage to the person obtaining the bond.

9 *J. Appleman, Insurance Law and Practice* §5291 at 89 (1943).

Defendants are also entitled to a judgment in their favor by virtue of clauses in each bond which terminate coverage as to any employee immediately upon discovery by the employer of any dishonest or fraudulent conduct by that employee. A clause such as this was given effect in *City Loan & Sav. Co. v. Employers' Liability Assur. Corp., Ltd., supra.* The bonds in that case provided that they "shall be deemed cancelled as to any Employee . . . immediately upon discovery

by the Insured or by any partners, or officers thereof not in collusion with such Employee, of any fraudulent or dishonest act on the part of such Employee." In that case, the employer discovered dishonest conduct by one of its employees in 1956, and, since the bond was issued in 1957, the acts of dishonesty discovered after the effective date of the bond were not covered. Other cases which have voided coverage under such clauses because the insured knew of prior acts of dishonesty by its bonded employee include *First Nat. Bank of Sikeston v. Transamerica Ins. Co.* 514 F.2d 981 (8th Cir. 1975) and *Ritchie Grocer Co. v. Aetna Casualty & Sur. Co.*, 426 F.2d 499 (8th Cir. 1970). Accordingly, since CDW is charged with knowledge on or before March 16 of Barksdale's dishonesty, the INA and Hartford bonds were cancelled as to him before they became effective on March 25. The affirmative defense was proved as a matter of law and defendants are entitled to a judgment nov. This conclusion, of course, eliminates the need to consider other grounds argued by defendants in their motions for judgment nov or in the alternative for a new trial.

The Court would also like to point out that its decision to grant a judgment nov does not affect its prior decision to dismiss St. Paul. Although this Court has ruled as a matter of law that CDW discovered dishonest conduct by Barksdale prior to March 25, this discovery does not impose liability on St. Paul because the dishonesty of falsifying the Request for Final Endorsement caused no loss to CDW.

IT IS, THEREFORE, ORDERED that the motions of defendants INA and Hartford for a judgment notwithstanding the verdict be granted for the reasons heretofore stated and the Clerk of Court shall enter judgment for the defendants.

AND IT IS SO ORDERED.

Robert F. Chapman
United States District Judge

July 8th, 1977
Columbia, South Carolina

APPENDIX B

C. DOUGLAS WILSON & COMPANY a South Carolina Corporation, Appellant,

v.

INSURANCE COMPANY OF NORTH AMERICA, PHILADELPHIA, PENNSYLVANIA, Hartford Accident and Indemnity Company, Hartford Connecticut, and St. Paul Fire and Marine Insurance Company, St. Paul, Minnesota, Appellees.

No. 77-2246.

United States Court of Appeals,
Fourth District
Argued Oct. 2, 1978.
Decided Jan. 10, 1979.

Before BUTZNER and HALL, *Circuit Judges*, and HOFFMAN,* *District Judge*.

K. K. HALL, *Circuit Judge*:

C. Douglas Wilson & Co. (Wilson), a mortgage broker, sustained losses in excess of $1,250,000 as a result of the mishandling of certain HUD/FHA loans by an employee, and filed a declaratory action in district court against its three defendant insurance carriers to fix their respective liabilities. On motion for nonsuit at the close of plaintiff's evidence, the district court dismissed St. Paul Fire and Marine Insurance Company (St. Paul) as a party. At the close of all the evidence, the jury returned a verdict for plaintiff against both the Insurance Company of North America (INA) and Hartford Accident and Indemnity Company (Hartford). The district court then granted a motion for judgment n. o. v. We affirm.

*Walter E. Hoffman, Senior District Judge, Eastern District of Virginia, sitting by designation.

To resolve the question of liability in this case we must focus attention upon the date of March 25, 1973, the dishonesty of J. L. Barksdale, then a vice president of Wilson, and the manner in which Wilson reacted to the discovery of Barksdale's dishonesty.

St. Paul was the fidelity bond insurer prior to March 25, 1973. INA and Hartford were the insurers after that date.[1] The St. Paul policy provided coverage only for losses *discovered* during the policy period.[2] The INA and Hartford policies expressly excluded coverage for losses resulting from the dishonest acts of any employee which occurred after the employer had knowledge of the employee's dishonesty.[3] The

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[1]The St. Paul policy provided $1,000,000 coverage with $500 deductible. The INA policy provided $8,000,000 coverage with $50,000 deductible. Wilson purchased the Hartford policy, which provided $50,000 coverage with $1,000 deductible, to fill this gap in the INA coverage.

[2]The St. Paul policy contained the following: ENDORSEMENT OR RIDER No. 3

• • • • • •

"RIGHTS AFTER TERMINATION OR CANCELLATION"'

"Section 17. At any time prior to the termination or cancellation of this bond as an entirety, whether by the Insured or the Company the Insured may give to the Company notice that it desires under this bond an additional period of twelve months within which to discover loss sustained by the Insured prior to the effective date of such termination or cancellation and shall pay an additional premium therefor. Upon receipt of such notice the Company shall give its written consent thereto; . . ."

[3]The INA policy provided: TERMINATION OR CANCELLATION

• • • • • •

Section 10.

• • • • • •

This bond shall be deemed terminated or cancelled as to any Employee—(a) as soon as the Insured shall learn of any dishonest or fraudulent act on the part of such Employee, . . .

The Hartford policy provided:

PRIOR FRAUD, DISHONESTY OR CANCELLATION

SECTION 6. The coverage of this Bond shall not apply to any Employee from and after the time that the Insured or any partner or officer thereof not in collusion with such Employee shall have knowledge or information that such Employee has committed any fraudulent or dishonest act in the service of the Insured or otherwise, . . .

district court ruled, as a matter of law, that St. Paul was not liable because Wilson discovered its losses after the St. Paul policy had expired, and that INA and Hartford were not liable because Wilson knew of the dishonesty of its vice-president before the effective date of their policies.

The facts may be stated briefly. Wilson is a wholly-owned subsidiary of NCNB Corporation. The genesis of this lawsuit is found in various loan practices of J. L. Barksdale, then vice-president of Wilson in charge of all multi-family construction loans insured by the Secretary of HUD through FHA. On March 16, 1973, Robert Shaw, NCNB's credit review officer, discovered during a routine audit that Barksdale was advancing construction monies to contractors before getting prior approval from HUD, which prior approval was one condition to participation in the HUD/FHA program. Shaw confronted Barksdale, who candidly admitted this practice; he also admitted that he falsely certified the dates and amounts of advances on standard HUD forms, to make those dates and amounts conform to the actual dates and amounts approved by HUD. Barksdale justified this practice by saying that ". . . all construction lenders in FHA projects were handling these [pre-advances and false certifications] on this basis and . . . FHA, or HUD, was aware of this practice. . . ."

Shaw, concerned about the situation, wrote a detailed memo to Wilson officials on March 18, 1973. A meeting was held the following day to discuss the situation, but no action was taken against Barksdale, although the practice of making pre-advances "came to a screeching halt." Wilson did not notify St. Paul, who was then the insurer on a fidelity bond, of Barksdale's actions, nor did it notify INA or Hartford, who six days later were to become the insurers. Various Wilson officials testified at trial that, at the time, they considered Barksdale's actions to be bad business practice and poor judgment, but did not consider them dishonest or illegal. Significantly, Wilson argued vigorously both at trial and on

appeal that no losses were occasioned by Barksdale's practice of making pre-advances.[4]

During the week of April 23, 1973, Wilson discovered that Barksdale had failed on several occasions to secure letters of credit which Wilson was obligated to hold in lieu of cash escrows required by FHA for its approval of permanent loan insurance for completed housing projects. As in the case of the pre-advances, Wilson discovered that Barksdale had falsely certified FHA forms that he had in fact secured these letters of credit. Wilson considered these acts, which had the effect of exposing Wilson to substantial losses, dishonest and illegal, and immediately fired Barksdale and notified St. Paul, INA and Hartford of a potential claim. Wilson eventually suffered over $1,250,000 in losses due to Barksdale's failure to secure the letters of credit, and this action was filed in district court to determine which if any of the three insurers were liable for the losses.

THE INA AND HARTFORD POLICIES

Both the INA and Hartford policies provided that coverage was deemed terminated or cancelled as to any employee as soon as the Insured had knowledge that the employee had committed fraudulent or dishonest acts. Wilson admits, "with the benefit of hindsight," that Barksdale's false certification to HUD of the dates and amounts of pre-advances was a dishonest act, but insists that at the time it reasonably considered this to be merely poor judgment and bad business practice. INA and Hartford argue that Barksdale's false certification of the pre-advances was dishonesty as a matter of law, and that Wilson had knowledge of this employee dishonesty before March 25, 1973, when the INA and Hartford fidelity bonds became effective. This would mean that, as to Barksdale, coverage under the bonds never went into effect.

Wilson's argument hinges upon the distinction it attempts to make between Barksdale's false certification of pre-

[4]Had Wilson anticipated that losses might result from the pre-advances, it could have elected a twelve-month extension of the St. Paul policy then in effect. See footnote 2, *supra*.

advances and his false certification concerning the letters of credit; the former, it urges, is "technical only," while the latter poses a much higher risk of loss exposure to Wilson. The district court found, and we agree, that this is a distinction without a difference. In both instances Barksdale certified false information on a HUD or FHA form, which form stated that criminal penalties attached for such false certifications,[5] for the purpose of influencing HUD or FHA actions. The smaller potential for loss exposure to Wilson does not render one violation "technical."

Wilson vigorously attempts to factually distinguish the authority cited by the district court, but we are persuaded by the reasoning in *City Loan and Savings Co. v. Employers' Liability Assurance Corp., Ltd.*, 249 F.Supp. 633, 656 (N.D. Ohio 1964) (citations omitted). (Sic)

> 'Dishonesty', as used in a fidelity bond, is to be interpreted according to its usual and ordinary meaning. To constitute dishonesty, the conduct need not amount to a crime and need only involve bad faith or a want of integrity or untrustworthiness or a disposition to lie or cheat or a faithlessness to a trust. To constitute dishonesty, there need not be an intent to profit or to cause a monetary loss to the employer.

Since we conclude that Barksdale's false certification of pre-advances constitutes dishonesty as a matter of law and that Wilson had knowledge of it before the inception of the INA and Hartford policies, and since Wilson concedes

[5]The forms contained the following language:

U.S. Criminal Code, Section 1010, Title 18, U.S.C., "Federal Housing Administration Transactions", provides in part:

> "Whoever, for the purpose of . . . influencing in any way the action of such Administration . . . makes, passes, utters, or publishes any statement, knowing the same to be false, . . . shall be fined not more than $5,000 or imprisoned not more than two years, or both."

that it did not notify INA and Hartford of Barksdale's dishonesty, we sustain the conclusion of the district court that under the terms of their respective policies INA and Hartford cannot be held liable for Wilson's losses. *See* footnote 3, *supra.*[6]

THE ST. PAUL POLICY

Wilson, INA and Hartford join in arguing that the district court erred in dismissing St. Paul from the case at the close of plaintiff's evidence. All of that evidence indicated that Wilson's losses were occasioned solely by Barksdale's failure to secure the letters of credit[7] and that this failure was not discovered until the week of April 23, 1973. The St. Paul policy provided coverage only for losses discovered during the policy period; the policy expired on March 25, 1973.

Defendants INA and Hartford were prepared to offer the testimony of J. L. Barksdale that Wilson had discovered the missing letters of credit, and thus its loss, before March 25, 1973. However, they did not file a cross-claim against St. Paul. The district court held that, even given the relaxed burden of proof in a declaratory action, it was the plaintiff's burden—not INA's or Hartford's—to establish St.

[6]The dissent notes that all of Barksdale's acts concerning the letters of credit occurred *before* Wilson's discovery of his dishonesty, and from this argues that we are giving the termination clauses retroactive effect by holding that INA and Hartford have no liability for losses resulting from these prior acts. *See* pp. 1290-1291 *infra.* We agree that in the usual situation, where the same insurer is on the risk throughout the entire time period at issue, coverage for losses resulting from acts occurring before the employer's discovery of employee dishonesty would not be affected by subsequent operation of the termination clause. But here, the dissent would have INA and Hartford assume liability for losses resulting from acts committed before the inception of their respective policies by an employee who was *never* within the coverage of the policies. This is an untenable result.

Had Wilson elected to extend its coverage under the St. Paul policy, its option as a matter of right, *see* note 2 *supra,* St. Paul would have been liable for the after-discovered losses.

[7]Upon questioning at oral argument, Wilson's counsel continued to insist that it sustained no losses as a result of the pre-advances, and that there was no causal relationship between the pre-advances and the ultimate losses.

Paul's liability. See 6A Moore's Federal Practice ¶ 57.31, at 266-71 (2d ed. 1974). Wilson presented no evidence upon which St. Paul could be held liable. INA and Hartford, who did not file a cross-claim against St. Paul and thus did not assume the role of plaintiff as against St. Paul, should not be heard to complain.

CONCLUSION

We find Wilson's argument that the district court failed to consider the materiality of Wilson's non-disclosure to the insurers to be refuted both by the language in the courts' opinion and by the evidence. The fact of an employee's known dishonesty cannot be non-material where the insurer is underwriting a fidelity bond. *Graham v. Aetna Insurance Co.*, 243 S.C. 108, 132 S.E.2d 273 (1963), relied upon by Wilson, is inapposite.

We agree with the district court's analysis of the law of waiver and estoppel and with his conclusion that these defenses are unavailing where, as here, the effect would be to add to or extend policy coverage and, in any event, the defenses have no support in the evidence.

In light of our holding that neither INA nor Hartford may be held liable for Wilson's loss because of Wilson's non-disclosure of employee dishonesty, we need not consider the additional issue raised by Hartford of whether it may not be held liable because its coverage is written on a "loss sustained" basis rather than on a "loss discovered" basis.

The unfortunate position in which Wilson finds itself was occasioned in part by sheer bad luck in timing as to the change in insurers and in part by the poor judgment of its own officers. However, mindful of Justice Holmes' admonition, we cannot use this hard case as a vehicle to make bad law. Each issue raised in this appeal is analyzed at length in the district court's opinion, and we affirm on the basis of that opinion.

AFFIRMED.

WALTER E. HOFFMAN, *District Judge*, concurring in part and dissenting in part:

I join my colleagues in affirming the action of the district court in sustaining a motion for a directed verdict in favor of St. Paul Fire and Marine Insurance Company (St. Paul) made at the conclusion of plaintiff's evidence where no cross-claim had been filed.[1] At this point my agreement disappears and I would reverse the judgment n. o. v. entered by the district court and now affirmed by the panel majority for the following reasons:

> (1) The evidence and inferences drawn therefrom were sufficient for the jury to find a verdict for the plaintiff, C. Douglas Wilson & Co. (CDW), which verdict should now be reinstated as to both defendants, INA and Hartford.
>
> (2) As to both fidelity bonds, the district court and the panel majority have misconstrued the effect of, and given retroactive treatment to, the termination and cancellation provisions of the policies. However, this point is immaterial if (1) above is correct.

As I view the facts and inferences fairly drawn therefrom, taken in the light most favorable to CDW which prevailed before the jury, they involve the knowledge which existed in the minds of certain officers and directors of CDW at and immediately prior to March 25, 1973, when the St. Paul's fidelity bond terminated and INA and Hartford assumed

[1]The question of burden of proof is one of substance, not procedure, and is governed by the substantive law of the case in a diversity action. *Cities Service Oil Co. v. Dunlap*, 308 U.S. 208, 60 S.Ct. 201, 84 L.Ed. 196 (1939); *Palmer v. Hoffman*, 318 U.S. 109, 117, 63 S.Ct. 477, 87 L.Ed. 645 (1943); *Dick v. New York Life Ins. Co.*, 359 U.S. 437, 446, 79 S.Ct. 921, 3 L.Ed.2d 935 (burdens of proof are substantive). It is clear in the present case that plaintiff (CDW) at all times contended, and still contends, that the discovery of any dishonest act occurred *after* the crucial date of March 25, 1973. Since South Carolina, in a declaratory judgment action, requires the plaintiff to sustain its burden of proof in the same manner as in an ordinary civil action, *Martin v. Cantrell*, 225 S.C. 140, 81 S.E.2d 37 (1954), I join the panel majority in this affirmance. See also: *National Bank of South Carolina v. American Surety Co. of New York*, 67 F.2d 131 (4th Cir. 1933).

the coverage. Did the admitted facts and inferences present an issue of fact, or was it clearly a matter of law which was solely in the province of the court? If it was a mixed question of law and fact, then under the authorities it was for the jury.

On Friday, March 16, 1973, Shaw, an internal auditor and assistant vice-president for NCNB Corporation, the parent company of CDW, was engaged in "a continuing process of my becoming familiar with their (CDW's) procedures, practices in the extension of this type of credit and the administration of these credits." He, and others employed by NCNB, were familiarizing themselves with the operations of CDW, which corporation had been acquired by NCNB in August, 1972. Shaw examined five multi-family project loan files at CDW and discovered that in three files the schedule of loan disbursements for the construction projects, as reported to FHA/HUD, did not match the CDW ledger as to *when* the loan funds were actually advanced. In each instance, however, the total amount of funds advanced was correct. Shaw's concern was that the funds had been advanced prior to the dates certified to FHA/HUD. Shaw immediately confronted J. L. Barksdale, the vice-president of CDW in charge of multi-family project loans, and requested an explanation. Barksdale candidly admitted that the FHA figures were incorrect, but explained that this was a common practice in such projects due to the administrative delays by FHA/HUD in getting approval to advance funds and, he further stated, FHA/HUD was aware of the practice.[2] Indeed, it sometimes took three to

[2]There is no suggestion that anyone with CDW, other than Barksdale, knew all the regulations and procedures of FHA/HUD in handling such matters. It is a fair inference to draw that Barksdale was aware of the handbook covering the responsibilities of HUD field officers during the construction period of an insured mortgage. On the first page of the handbook there appears:

> *Type and Amount of Advances.* If the application is for an initial advance of mortgage proceeds, the Field Office Director will determine that all deposited funds held in escrow (paragraph 1–1) have been disbursed. If it is for a second or a later advance, the

four weeks for a request for payment to be approved by FHA/HUD.

Shaw's conference with Barksdale occurred late Friday afternoon. He did not accept Barksdale's explanation at face value. On Sunday, Shaw prepared a memo for his superior, Addison Reese, the chairman of NCNB. On Monday, March 19—six days prior to the termination of the St. Paul fidelity bond—Shaw met with Robert Cashion, head of NCNB's mortgage banking subsidiaries and chairman of CDW, along with Calvin Ridgeway, president of CDW.[3] Shaw presented to these officers his memo which described the practice of advancing funds prior to FHA/HUD approval. As noted, the memo demonstrated that figures submitted to FHA/HUD contained incorrect dates and amounts. All parties agreed that preadvancing funds was a questionable business practice which exposed CDW to potential liability if FHA/HUD should approve a sum less than that advanced. The parties further agreed that Ridgeway would return to the CDW office in Greenville, South Carolina, and there review all the FHA/HUD loans to determine the extent of CDW's exposure to potential losses.[4] The practice of preadvancing funds came to a "screech-

mortgagee must state the cumulative amount of all advances made to the mortgagor, including the advance for which approval is being requested. This total is sometimes at variance with the total amount of advances approved, either because the mortgagee has advanced funds without HUD—FHA approval or because the stated total is incorrect. Any such variance must be accounted for and satisfactorily adjusted.

The HUD handbook is only important in that it supports Barksdale's comments to Shaw that FHA/HUD had knowledge of the practice of mortgagee's advancing funds prior to approval by FHA/HUD. Shaw admitted that he never looked at the reverse side of the Request for Final Endorsement form which contained a warning as to possible criminal violations.

[3]Ridgeway died prior to trial and did not testify by deposition.

[4]When Shaw returned to Greenville on April 16-17, 1973, he learned that no work had been done in determining the amount of preadvances (or over-advances) on the FHA/HUD projects. He then made a detailed inspection of all files and found that the over-advances aggregated more than $575,000. By this time the INA and Hartford bonds were in effect.

ing halt" as of March 19, 1973.

Cashion followed, on March 20, 1973, with a memo to Shaw which again referred to the preadvances. At no time did he suggest or intimate that there had been a dishonest or fraudulent act on the part of Barksdale. In fact, none of the officers or directors ever considered Barksdale's acts as dishonest or fraudulent, other than by way of hindsight when the subsequent losses involving letters of credit were discovered. Of course, the jury was not required to believe these officers and directors, but apparently it did by its verdict.

The fact that CDW was adequately[5] protected by a fidelity bond issued by St. Paul in 1971 and in effect until March 25, 1973, and that no consideration was given reporting Barksdale's acts to St. Paul, is a further inference that the officers and directors did not consider Barksdale's acts as dishonest or fraudulent.

During this entire period CDW was protected from employee dishonesty by the "Mortgage Banker's Blanket Bond" issued by St. Paul and acquired in 1971 when CDW was an independent corporation. When, in August, 1972, NCNB acquired the stock of CDW, NCNB elected to continue the St. Paul bond in effect until it expired on March 25, 1973.[6] On that date CDW became an insured under NCNB's blanket fidelity bonds. NCNB and its subsidiaries were insured with INA in the amount of $8,000,000 with a $50,000 deductible. NCNB also had, as of March 25, 1973, a supplemental bond with Hartford with $50,000 coverage and $1,000 deductible.

All of the bonds issued by the three insurance companies were "discovery" bonds, i. e., the particular company would be liable at the time of the discovery of the loss, not at the time the loss actually occurred.[7] CDW never suffered a proven loss

[5]The St. Paul bond afforded coverage to the extent of $1,000,000 with a deductible of $500.

[6]It may be that in August, 1972, when the stock of CDW was acquired by NCNB and CDW became a wholly-owned subsidiary, INA and St. Paul may have afforded duplicate coverage to CDW, but the case was not filed nor tried on this theory.

resulting from Barksdale's unauthorized preadvances or false certifications to FHA/HUD. He continued to be employed by CDW until April 23, 1973. No reprimand was ever issued to Barksdale although he was instructed to desist his prior actions with respect to preadvances or over-advances.

On April 23, 1973, the officers of CDW learned of a separate problem involving Barksdale. A customer informed the officers that his construction company would become insolvent if it did not receive an immediate loan of $1,000,000 working capital. The customer added that CDW might as well authorize the loan since letters of credit drawn on North Carolina National Bank, another NCNB subsidiary, would be called if his company became insolvent. CDW's officers were shocked to receive this information. They confronted Barksdale who admitted that he had never obtained the letters of credit to secure the loan. That night Barksdale's resignation was received and accepted effective April 27, 1973, and the fidelity companies were notified. Barksdale later entered pleas of guilty to three counts of falsely certifying to the FHA that letters of credit had been obtained from lending institutions in connection with FHA projects. Barksdale was neither charged nor indicted for authorizing the preadvances of funds

[7]Hartford insists that its bond was issued on a "loss sustained" basis. This would be a valid defense as the loss was clearly sustained during the existence of the St. Paul policy but for the provisions of General Agreement C of the Hartford bond which reads:

> If the coverage of this Bond is substituted for any prior bond or policy of insurance carried by the Insured or by any predecessor in interest of the Insured, which prior bond is terminated, cancelled or allowed to expire as of the time of such substitution, the Underwriter agrees that the bond applies to loss which is discovered in Section 1 of the Conditions and Limitations and which would have been recoverable by the Insured or such predecessor under such prior bond or policy except for the fact that the time within which to discover loss thereunder had expired. . . .

Since Hartford's bond does not clarify the meaning of the word "substitution," under the facts of this case Hartford was the substitute for St. Paul to the extent of the limits provided.

or the false certification on the forms submitted to FHA/HUD relative to the preadvances.

By reason of the missing letters of credit, CDW sustained a loss of approximately $1,250,000. Of course, when the facts regarding the missing letters of credit were discovered, the "hindsight" of Barksdale's prior activities branded him as dishonest.[8] But, as noted, the crucial date is what was known prior to noon on March 25, 1973. When this action was brought, St. Paul defended on the ground that the dishonest act of Barksdale was not discovered prior to noon on March 25; INA and Hartford contended otherwise.[9] As ably stated by Judge Chapman in his charge to the jury, "But the defendants [INA and Hartford] contend that the bonds did not cover Barksdale because C. Douglas Wilson knew that Barksdale had committed a dishonest act [with respect to the unauthorized preadvances and false certification to FHA/HUD] and C. Douglas Wilson did not advise the bonding company of this dishonest act prior to the effective date of the policy, March 25th, 1973. Defendants further contend that the management of C. Douglas Wilson approved of or acquiesced in—that means went along with—the actions of Barksdale and may not now recover."

By his charge, to which there was no exception of substance,[10] Judge Chapman also directed the jury to consider:

[8]Even after the missing letters of credit came to light, the Acting Regional Director of HUD, speaking through Clifton G. Brown, the Area Director, by memo dated May 4, 1973, characterized Barksdale's prior activities as "poor judgment" without "evidence of, or intent of, monetary gain or personal betterment to Mr. Barksdale." As late as May 18, 1973, Addison Reese wrote a memo commending Shaw for first running up "the warning signals."

[9]There were other defenses asserted but they are not material to the issues now before the court, including the fact that INA and Hartford did not issue their riders attaching coverage for CDW until after these two companies had full knowledge of Barksdale's activities. The district court declined to let the issues of waiver and estoppel to be submitted to the jury.

[10]Plaintiff took exception for the reason that Judge Chapman failed to tell the jury that the duty to disclose was relative to a "dishonest act which was material to the risk." Defendants took no exceptions. As the jury found for the plaintiff, any omission as to materiality is of no consequence.

Third, did the act of making false certifications as to pre advances or other advances represent a false or a dishonest act?

And Fourth, if you find that such certification of pre advances or over advances was a dishonest act, should a reasonable employer, under the same circumstances and with the same facts and at the same time, have realized that such certifications of pre advances and over advances were dishonest and fraudulent?

By his order of July 8, 1977, entering judgment n. o. v. in favor of INA and Hartford, Judge Chapman effectively reversed himself and, in substance, concluded that the plaintiff's case should never have gone to the jury.[11] He acknowledged that the burden of proof rested upon the defendants to establish that CDW knew of Barksdale's dishonest act prior to the effective date of the INA and Hartford policies, to-wit, March 25, 1973. However, he concluded that "the verdict of the jury is against the clear weight of the evidence and should be set aside." Conceding as I must that the weight of the evidence may preponderate and, if trying the case without a jury, I may have arrived at the conclusion that the plaintiff should not prevail, I cannot agree that a jury question was not presented. Effectively, Judge Chapman held that the "false certifications made by Barksdale and others at his direction on the Request for Final Endorsement cannot be considered as anything but dishonest" and that this is a matter of law. Stated otherwise, all false certifications constitute a dishonest act as a matter of law.

Judge Chapman also held: "There can be no distinction between the false certification on the Mortgagee's Certificate and the false certification on the Request for Final Endorsement. If one is dishonest, then the other necessarily is also."

[11]Judge Chapman wrote an excellent opinion. My disagreement is confined to the fact that a jury question was presented.

He rested his decision not on the question of preadvances or over-advances but on CDW's knowledge of the false certifications prior to March 25 and said that CDW had knowledge of these certifications which were dishonest as a matter of law.

The meaning of the word "false", used almost exclusively in cross-examination of the officers of CDW and emphasized by the lower court and panel majority opinions, is susceptible of more than one interpretation. In one sense it is defined by Webster's Third New International Dictionary as "dishonest", "deceitful" and "deceptive"; in another sense it is referred to as "erroneous", "incorrect", "defective", "imprudent" and "unwise". And the definition of the word "certification" does not essentially assist in the solution of the problem. To us, as lawyers and judges, we are prone to imply the criminal aspects of "dishonesty". To others, as laymen and business people, the words of dishonesty and criminal responsibility are not nearly so conclusive. This is the reason that the lower court correctly charged the jury on the "reasonable man" test.

I

Under long-standing principles of insurance law, the question of whether an act is "dishonest" or whether a reasonable man should have perceived an act to be dishonest, is for the jury. The problem arises in several contexts. An employer (insured) will allege that a certain act on the part of an employee was dishonest in order to bring a loss within the coverage of a fidelity bond. Likewise, an insurance company will endeavor to terminate coverage under the policy by attempting to show that an employer had knowledge of a dishonest or fraudulent act by an employee prior to the dishonest act which occasioned the loss. The insurance company, upon whom the burden of proof rests to prove this affirmative defense, will attempt to label the prior act as "dishonest", rather than merely unwise, negligent, poor business practice or lacking

in the exercise of good judgment, in order to defeat coverage.[12] Finally, the question of when a dishonest act was first discovered may become important in determining whether an insured was in compliance with the notice provisions of a policy.

The case law and authorities are in substantial agreement as to the role of the jury in determining whether an act is dishonest. 13 *Couch on Insurance,* 2d, § 49:231, states:

> Whether the insured had such knowledge as required him to give notice as stipulated in the policy is for the jury where some evidence tends to show the required degree of knowledge. Whether or not the employer discovered a loss is generally a jury question, and the question whether the insured acquired knowledge from which he might reasonably conclude that his employee had been committing fraudulent and dishonest acts is a mixed question of law and fact to be submitted to the jury.[13]

See, also: 11 Appleman, *Insurance Law and Practice,* § 6978, saying:

> Whether or not the employer prior to the defalcation upon which an action is based had obtained knowledge of dishonest acts was a question of fact.

In a frequently cited and leading case on the subject, Chief Judge Cardozo, later Mr. Justice Cardozo, while sitting

[12]In argument before this court, counsel for INA stated that if the employer learned, or should have known, that an employee had lied, this would be a dishonest act and coverage would not attach as a matter of law. I cannot approve of such a strained construction of fidelity bond provisions. Thus, according to INA, if any employee, with knowledge of his employer, had falsified the hour he returned from lunch, or some other trivial detail, this would be a dishonest act and there would be no coverage as to an after-discovered loss.

[13]The present case was tried under South Carolina law which, in this diversity action, is binding upon us. Although presented in a different context, *Planter's Savings Bank of Greer v. American Surety Co.,* 177 S.C. 363, 181 S.E. 222 (1935), intimates that the timing of notice required for the discovery of a dishonest act is for the jury.

with the Court of Appeals of New York, held that determination of the nature of an act is for the jury. *World Exchange Bank v. Commercial Casualty Insurance Company,* 255 N.Y. 1, 173 N.E. 902 (1930), involved a teller who paid funds to a depositor of the bank against uncollected items of deposit in violation of a rule of the bank. The teller believed the items, which were still in the course of collection, to be good. A loss of nearly $23,000 was suffered as a result of the teller honoring the depositor's checks. The bank sued the fidelity insurance carrier on a bond which insured against loss resulting from a dishonest *or* criminal act by an employee. The bank obtained a jury verdict. The Appellate Division reversed and ordered a new trial. The Court of Appeals reversed the Appellate Division and, speaking through Chief Judge Cardozo, held that the teller's acts could not be held to be dishonest as a matter of law, saying:

> We think the quality of the act is not so obvious and determinate as to exclude opposing inferences. . . . Criminal the act was not, unless done with criminal intent. . . . The presence of that intent is not, in the setting of these circumstances, an inference of law. The question is perhaps closer whether the act within the meaning of the policy must be said to be "dishonest", for dishonesty within such a contract may be something short of criminality. . . . The appeal is to the mores rather than to the statutes. Dishonest, unlike embezzlement or larceny, is not a term of art. Even so, the measure of the meaning is not a standard of perfection, but an infirmity of purpose so opprobrious or furtive as to be fairly characterized as dishonest in the common speech of men. "Our guide is the reasonable expectation and purpose of the ordinary business man when making an ordinary business contract". . . .
>
> If this standard is to govern, we think the quality of the teller's act is for the triers of the facts. He was

not acting *lucri causa*, to gain some benefit for himself. He was not acting with the thought of giving anything to anyone, or so the triers of the fact might say. The money was due if the uncollected checks were good. He believed them to be good, for, with or without sufficient reason, he believed them to be certified. He ought, even then, to have consulted his superior instead of venturing to act alone. None the less, his only object was the furtherance of the business without useless fuss and pother. (Sic) The act was a wrongful one, very likely a technical conversion, certainly a departure from instructions, but in the common speech of men there would be reluctance to describe it as flagitious or dishonest. . . . The act, even if prohibited, was not so radical a departure from the general business of the bank or the functions of the actor as to exact an imputation of dishonest when there was innocence of motive.

In *Federal Deposit Insurance Corporation v. Lott*, 460 F.2d 82 (5th Cir. 1972), one of the issues presented was whether the bank directors had knowledge of the president's previous fraudulent and dishonest conduct. In upholding a jury verdict in favor of the F.D.I.C., as receiver of the bank, the court said:

> In applying the test [on a motion for judgment n. o. v.] we must bear in mind what type information the directors must have had in order to nullify Aetna's liability under the bonds. The fact that the directors may have had knowledge of irregularities and violations, i. e., the holding of excessive cash items and exceeding the legal loan limit, is not by itself sufficient to trigger the bank's obligation to notify Aetna. . . . [N]otice is not required when the obligee merely suspects or has reason to suspect wrongdoing. . . . This issue was particularly well suited for jury determination and upon review of the evidence we think

> reasonable men might have reached different conclusions as to its outcome. . . . Viewing this evidence in favor of the verdict as true and giving it the benefit of all permissible inferences that help sustain the jury's decision, we find it sufficient to support the jury's findings.

As stated by Cardozo, a party need not be technically guilty of a criminal offense in order to come within the provisions of a policy indemnifying against losses resulting from criminal acts. Conversely, as stated in 13 *Couch on Insurance*, 2d, § 46:251:

> It has been held that acts of an employee, which, while technically illegal, are not regarded by the insured as dishonest or as a default on the part of the employee, do not come within a provision of the policy to the effect that the insurer shall be liable only as to losses occurring through dishonest or fraudulent acts prior to the time that the insured had notice of default on the part of the employee.

See also: 9 Appleman § 5668.

Cardozo observed that the teller's act in *World Exchange Bank, supra*, was very likely a technical conversion. It has been held that although a statute makes it a penal offense for a bank president to borrow money from his bank without authorization of the board of directors, it does not follow that loss from such a loan gives rise to liability under the bond where the bank president had been following this practice for a period of three years and there was no concealment with respect to bank records. As noted by the Wisconsin Supreme Court in holding for the bonding company:

> The surety company did not undertake to guarantee the contractual indebtedness of Sprague to the bank. While these loans and overdrafts were irregular, and no doubt in a sense dishonest, they did not constitute

that character of dishonesty within the contemplation of the parties to the bond. *Parker v. Sprague,* 214 N.W. 361, 362 (1927).

Again, in *Bank of Commerce and Trust Co. v. Union Indemnity Co.,* 174 La. 1014, 142 So. 156 (1932), an officer of a bank who withdrew a month's salary in advance from the bank in violation of a state statute which made it a misdemeanor for him to borrow money without authorization, was held not to have committed a dishonest act sufficient to terminate coverage under a blanket fidelity policy. And a *false certification* by an employee that he has made a personal inspection required by the terms of his employment does not constitute dishonesty *as a matter of law, Universal Credit Co. v. United States Guarantee Co.,* 321 Pa. 209, 183 A. 806 (1936), although in this case the jury found for the bonding company.

I mention the foregoing authorities as only a sample of the many cases which could be cited. Judge Chapman and the panel majority emphasize the apparent violation of 18 U.S.C. § 1010 making it a felony to issue a statement, knowing it to be false, for the purpose of influencing in any way the action of FHA. However, if we were confronted with a criminal case involving Barksdale, questions of criminal intent and attempts to influence FHA would give rise to serious issues if confined to the preadvances made by CDW.

The apparent lack of inclination to thoroughly discuss the authorities on the part of the panel majority, and to a somewhat lesser extent by Judge Chapman, prompts the writing of this lengthy dissent. The panel majority relies on *one* case, *City Loan and Savings Co. v. Employers' Liability Assurance Corp., Ltd.,* 249 F.Supp. 633 (N.D.Ohio 1964). Judge Chapman likewise directs his primary attention to this case. The facts in the Ohio case are so totally different that I have difficulty determining the heavy reliance upon it. In that case the insured had clear knowledge of dishonesty on the part of an employee as early as February, 1956, yet

allowed the employee to remain in its employ, albeit with instructions to cease the dishonest practice. The insured subsequently acquired knowledge that the practices were being continued, yet still took no action to discharge the employee. Eventually the scheme involving fictitious accounts in funding a car dealer collapsed and a loss of over $350,000 was discovered. The insured then gave notice, in June, 1958, that loss had resulted from the dishonesty of an employee. In a case tried by the court *without a jury* Judge Battisti found that only $548.90 of the total loss could be said to have been incurred prior to February, 1956, when the first dishonest acts were discovered. The evidence of knowledge of the dishonesty of the employee was so apparent to the employer in February, 1956, that the possible liability of the bonding company could not be considered under Judge Battisti's lengthy opinion which covers 26 pages and includes 56 findings of fact and 15 conclusions of law. I am disturbed that an important case such as the one at bar is disposed of by reference to one district court opinion which is factually inapposite.

There is, however, a case relied upon by Judge Chapman which requires some discussion, although it is somewhat the reverse of the situation here presented in that the New Jersey Supreme Court held the bonding company liable as a matter of law in a matter involving false certification. In *Mortgage Corp of New Jersey v. Aetna Casualty & Surety Co.,* 19 N.J. 30, 115 A.2d 43 (1955), a factual situation similar in some respects to the present case was involved. A mortgage company employed one Harrison to inspect building sites and to make certifications on the basis of which the mortgage company would disburse loan funds to the borrower. Under the terms of the loan, funds were to be disbursed at various stages of construction. Beginning in 1941 Harrison stopped making personal inspections and began making his certifications on the basis of representations made by the contractor, all without knowledge or permission of the employer. Substantial losses were incurred as a result of the mortgage com-

pany's reliance on Harrison's certifications. At the first trial the jury returned a 10 to 2 verdict for the defendant (referred to as "no cause of action"), but the trial court granted a new trial on the ground that reasonable minds could not escape the conclusion that Harrison was guilty of dishonest acts. At the second trial the jury again returned a verdict for the defendant (no cause of action). The trial court then granted judgment n. o. v. for the plaintiff mortgage company. On appeal, the New Jersey Supreme Court noted that fidelity bonds indemnifying employers against dishonest acts of their employees are to be broadly construed. The court attempted to distinguish the case from *World Exchange Bank, supra,* and then held that Harrison's dishonesty clearly fell within the coverage of the policy. However, the court split four to three on this issue and the dissent argued that the particular set of words used in the contract, i. e., "dishonest, fraudulent or criminal act," were manifestly selected to exclude liability for negligence no matter how gross. The dissent then defended the role of the jury in the American system:

> The issue here concerns the primacy of the jury in its constitutional sphere of resolving the facts and the inferences derivable from proved circumstances. It was the exclusive province of that tribunal to assess the proofs and determine whether the elements of fraud or dishonesty within the concept of the contractual indemnity had been established by a preponderance of the evidence. The question of one's intent or belief, of a fraudulent or dishonest design or purpose, is ordinarily in its very nature an inquiry for the jury. . . . And the terms of indemnity, as we have seen, import moral or conscious wrong or delinquency. Only when the proofs fairly and reasonably admit of but one conclusion does the question become one of law for the court. Where the evidence is sufficient to raise the question of intent, it is the duty of the court to submit the question to the jury.

The New Jersey case goes far in holding that the issues of fraudulent and dishonest acts may be for the court. The only pertinent distinction between the case at bar and the New Jersey case is that we are here confronted with the knowledge of the employer which played no part in the judgment n. o. v. in favor of the insured employer in the New Jersey situation.

The opinion of the panel majority and the able opinion of Judge Chapman each fail to discuss the *issue of intent* which, according to law, is critical. I express serious doubts whether Barksdale could have been convicted on a charge involving false certification as to preadvances when his intent is considered without regard to his later discovered defalcation pertaining to the letters of credit. While admittedly a proven criminal act is not required, the issue of intent is very material in determining whether a dishonest act was committed by Barksdale and whether the officers and directors of CDW should have known that the act was dishonest.

The New Jersey case found two juries and three justices in sharp disagreement with two trial judges and four justices over whether false certifications by an individual constituted dishonest acts or something less than dishonesty. While I am inclined to agree with the minority, the differences of opinion reinforce the logic of Cardozo's opinion which was cited by both the majority and dissenting opinions where he said:

> We think the quality of the act is not so obvious and determinate as to exclude opposing inferences. . . . If this standard is to govern, we think the quality of the teller's act is for the triers of the facts. 173 N.E. at 903-4.

It previously has been noted that the insured or the insurer may desire a broad or narrow interpretation of the word "dishonesty", depending upon whether the issue in question is one of coverage under the policy or termination thereof due to prior acts of the employee. We should bear in mind that a fidelity bond "is to be interpreted in light of its nature

as a contract of insurance, and in view of its purpose as such, and with a great desire of liberality in favor of the insured against the insurer." *Curran & Treadaway v. American Bonding Co.*, 193 La. 763, 192 So. 335, 338 (1939); *Mortgage Corporation of New Jersey v. Aetna Casualty & Surety Co., supra*, 115 A.2d at 46. And as the Supreme Court has said in *American Surety Company v. Pauly* (No. 1), 170 U.S. 133, 144, 18 S.Ct. 552, 556, 42 L.Ed. 977 (1898):

> If, looking at all its provisions, the bond is fairly and reasonably susceptible of two constructions, one favorable to the bank and the other favorable to the surety company, the former, if consistent with the objects for which the bond was given, must be adopted, and this is for the reason that the instrument which the court is invited to interpret was drawn by the attorneys, officers, or agents of the surety company. This is a well-established rule in the law of insurance.

At times it would appear that courts apply different rules in determining whether acts prior to coverage were dishonest than they would in finding dishonesty after issuance so as to come within the coverage of the policy. In *Maryland Casualty Co. v. Clements*, 15 Ariz.App. 216, 487 P.2d 437, 442 (1971), the Court of Appeals of Arizona noted that two entirely different issues were involved:

> In determining an employer's knowledge of prior acts, the question usually is not whether in light of the facts, including the employee's subjective intent, the employee's acts were *in fact* dishonest, but rather whether *based upon the facts known to the employer*, the employer should reasonably have perceived the dishonesty. In the coverage situation an entirely different yardstick applies—were the acts *in fact* dishonest?

Judge Chapman held and the panel majority agrees that there can be no distinction between the false certification on the schedule of advances and the false certification regarding the letters of credit. Stated otherwise, if CDW had knowledge prior to March 25 that Barksdale had made false certifications, then CDW had knowledge of prior dishonest acts. This does not necessarily follow and, to a great extent, is dependent upon Barksdale's intent. His false certifications regarding the preadvances are closely analogous to a depositor "floating" checks or a teller accepting checks on accounts he knows have insufficient funds to be covered. In either case the individual may have an interest to defraud the bank or the payee. On the other hand, the individual may fully intend to deposit sufficient funds to cover the check before it is posted. Courts have consistently held that questions of intent such as these are matters for the jury. Barksdale's intent in preadvancing funds on construction loans and falsely certifying same to FHA was not, as a matter of law, a dishonest act as he had no intent to defraud FHA or his employer. In effect, Barksdale was "floating" insurance coverage for the proceeds advanced in expectation that FHA would approve the advancement. The nature of Barksdale's acts should be considered in the context of practices in the mortgage business, rather than being labeled dishonest on what the jury may have deemed a technical violation of a statute.

In the many authorities reviewed only one, the New Jersey case referred to herein, stands out as a principle guiding the facts of this case that these issues may be taken away from a jury as a matter of law. And I would suspect that the desire to compensate the insured in an action against an insurance company may have been the primary reason why the majority took such action in the New Jersey case.

Nor can I believe that the South Carolina Supreme Court, if met with a factually identical problem, would hold that Barksdale's initial acts constituted dishonesty as a matter of law. In *Peurifoy v. Loyal*, 154 S.C. 267, 151 S.E. 579, 589 (1930), the court suggested the standard as to how the state

of mind of officers and directors of the employer should be treated. That case involved embezzlement by the bank's president and an action was brought on the bank's fidelity bond. The surety company asserted that the bank had failed to give notice within ten days after the discovery of the loss as required by the bond. Thus, the time of discovery of the dishonest act was crucial (as in the present case) to the decision. In summary, the South Carolina Supreme Court said:

> [I]t is clear that neither the cashier nor either of the two directors ever discovered *any loss* within the meaning of the bond. The evidence is that, so far as their knowledge and belief was concerned, they did not think there had been or would be any loss. They believed the matter to be an irregularity, but not a dishonest act. They had implicit faith in Mr. Mauldin, the president of the bank, and at no time does it appear that any one of them felt that he had *discovered a loss* to the bank. To hold that the cashier and these two directors became duty bound to give notice to the surety company that they had *discovered a loss* under the terms of the bond would be to require them to give notice of something they neither knew nor believed.

Peurifoy v. Loyal, supra, is not cited, mentioned or discussed in either the opinion of the district court or the opinion of the panel majority. While I realize that *Peurifoy* pertained to the discovery of a loss, whereas here we are involved with the discovery of a dishonest act, I feel that the principles are very similar and I cannot approve of the total lack of discussion of South Carolina authorities which are controlling in this diversity case.

Much of the same effect is *Fidelity & Deposit Co. of Maryland v. People's Bank of Sanford,* 72 F.2d 932 (4th Cir. 1934), a nonjury case, in which Judge Parker said:

> The defendant would have the worst construction put on that transaction and conclude therefrom that the cashier was dishonest and unworthy of confidence or trust; that the bank had actual knowledge thereof, and fraudulently withheld the information from the innocent surety, which amounted to a fraud on it, warranting the court in canceling the bond. It is unreasonable to conclude that the bank would have retained him as cashier from 1921 to 1927 and clothed him with the full control of the bank if it thought he was unworthy of trust.[14]

The panel majority and Judge Chapman have disregarded the admonition of our great Chief Judge Parker when, in *Burcham v. J. P. Stevens & Co.,* 209 F.2d 35 (4th Cir. 1954), he said:

> It is well settled that on a motion for a directed verdict or on motion for judgment n. o. v. based on such motion, the evidence must be considered in the light most favorable to the party against whom the directed verdict or the judgment n. o. v. is asked, that any conflict in evidence must be resolved in his favor and that every conclusion or inference that can be legitimately drawn therefrom in his behalf must be drawn.

The guiding principles have been violated by the panel majority opinion of affirmance.

II

Assuming *arguendo* that CDW officers had knowledge of dishonesty on the part of Barksdale prior to March 25, it is still in error to hold that INA and Hartford have no liability on their bonds by reason of their contract provisions. The

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[14]There is, as a matter of law, a presumption of honesty. A mere suspicion of dishonesty cannot be equated with the discovery of dishonesty. *Fidelity & Casualty Co. of New York v. Bank of Timmonsville,* 139 F. 101 (4th Cir. 1905).

district court based nonliability on two theories: 1) the termination clauses in each bond terminate coverage as to any employee immediately upon discovery by the employer of any dishonest or fraudulent conduct by that employee, and 2) under a warranty theory the insured has a duty to disclose material circumstances affecting the situation of the parties which are within the knowledge of the employer procuring the bond. Neither theory is applicable to the circumstances of this case.

The INA bond contains the following provisions for "Termination or Cancelation":

> Section 10.
>
> • • • • • •
>
> This bond shall be deemed terminated or canceled as to any Employee—(a) as soon as the insured shall learn of any dishonest or fraudulent act on the part of such Employee, without prejudice to the loss of any Property then in transit in the custody of such Employee, or (b) fifteen days after the receipt by the insured of a written notice from the Underwriter of its desire to terminate or cancel this bond as to such employee.

The Hartford bond contains a somewhat different provision:

> Section 6. The coverage of this bond shall not apply to any Employee from and after the time that the Insured or any partner or officer thereof not in collusion with such Employee shall have knowledge or information that such Employee has committed any fraudulent or dishonest act in the service of the Insured or otherwise, whether such act be committed before or after the date of employment by the Insured.
>
> If, prior to the issuance of this Bond, any fidelity insurance in favor of the Insured or any predecessor in interest of the insured and covering one or more of the Insured's Employees shall have been canceled as to any such Employees by reason of the giving of written notice of cancelation by the insurer issuing such fidelity insurance, whether the Underwriter or not, and if such Employees shall not have been reinstated under the coverage of such fidelity insurance or superseding fidelity insurance, the Underwriter shall not be liable on account of such Employees unless the Underwriter shall agree in writing to include such Employees within the coverage of this bond.[15]

The defendants contend that Barksdale was excluded from the bond under the exclusion provisions of the policy. Section 1 of the INA bond covers nine paragraphs of exclusions, none of which apply to this case. Section 2 of the Hartford bond contains a more limited exclusion not applicable to this case. However, while I do not regard Barksdale's situation as excluding him from coverage, I agree that the Conditions and Limitations are covered by Section 10 of the INA bond, and Section 6 of the Hartford bond.

The Hartford bond likewise contains a further provision as follows:

> Section 12. This Bond shall be deemed canceled as to any Employee: (a) immediately upon discovery by the Insured, or by any partner or officer thereof not in collusion with such Employee, of any fraudulent or dishonest act on the part of such Employee; or (b) at noon, standard time as aforesaid, upon the effective date specified in a written notice mailed to the Insured. . . .

The language of the two Hartford clauses differs in one respect: Section 12 refers to cancelation of the bond, whereas

[15]There is no contention in this case that St. Paul, the predecessor to INA and Hartford, ever gave any notice of cancelation as to Barksdale. The section is quoted as it tends to show that the noncoverage provision was intended to apply to after-discovered dishonesty.

Section 6 refers to coverage of the bond. The legal effect of the two clauses and the INA clause is probably the same. As soon as an employer learns that an employee has committed a dishonest act, that employee is no longer covered by the bond as to losses which may arise from *subsequent* dishonest acts of that employee. This is the obvious purpose of these clauses. Does it automatically protect a subsequent surety for *prior* acts which occurred when the bond was not in effect?

> In 13 *Couch on Insurance*, § 46:247, it is said:
> Apart from any question of giving notice of default, an employer who retains in his employment an employee who has been guilty of such conduct as constitutes a breach of the bond, and conceals the latter fact from the surety, cannot thereafter hold the fidelity insurer responsible for *subsequent defaults* of the employee. That is to say, where there is a continuing suretyship for the faithful discharge of duty, if the employer discovers that his employee or agent has been guilty of dishonesty in the course of the service, and thereafter continues him in such service, without notice to and the assent of the surety, express or implied, to such course, the surety is not liable for any loss arising from such dishonesty *during such subsequent service*. More simply stated, the insured may be barred or estopped from claiming recovery on the bond where it has knowledge of the course of conduct of the bonded employee which occasioned the loss. And an insurer is not liable for loss from any acts of fraud or dishonesty *committed by the employee after the employer becomes aware* of any act which may be made the basis of a claim. (Emphasis supplied)

Any other result would defeat the purpose of insurance and base recovery on chance. If an employer should discover on March 1 that an employee committed a dishonest act on Feb-

ruary 1 which caused no loss, and later discover on April 1 that the same employee had committed a separate act of dishonesty on January 1 that caused a loss of $1,000,000, it would be nonsensical to say that coverage as to that employee terminated on March 1 with the discovery of the first dishonest act. In the instant case all of Barksdale's dishonest acts concerning the letters of credit occurred long prior to the discovery by Shaw that Barksdale had made false certifications to FHA regarding the preadvances. It follows that the termination clauses, which act only prospectively, could have no effect on liability for losses which had already been incurred by the insured as a result of Barksdale's dishonesty.

The two cases cited by the court below to support its theory of termination are inapplicable. *First National Bank of Sikeston v. Transamerica Ins. Co.*, 514 F.2d 981 (8th Cir. 1975), involved a continuing pattern of wrongdoing similar to that in *City Loan & Savings Co., supra. Ritchie Grocer Co. v. Aetna Casualty & Sur. Co.*, 426 F.2d 499 (8th Cir. 1970), disallowed recovery for dishonesty by an employee who was known to have broken and entered a business for the purpose of stealing money and property prior to his employment by the insured and prior to the purchase of the fidelity bond. Other cases have more clearly distinguished between losses which occurred prior to the first discovery of dishonesty and those which occurred subsequent to that discovery. See *Lac Qui Parle Town Farmers Union Fire Ins. Co. v. Remsberg*, 195 Minn. 402, 263 N.W. 455, 456 (1935); *Los Angeles Athletic Club v. United States Fidelity & Guaranty Co.*, 41 Cal. App. 439, 183 P. 174, 178 (1919); *Perpetual Building & Loan Ass'n v. United States Fidelity & Guaranty Co.*, 118 Iowa 729, 92 N.W. 686, 688 (1902).

There remains for discussion the warranty theory, which would deny recovery to the insured for failure to disclose material facts concerning prior dishonest acts on the part of an employee. The INA bond contains the following warranty clause:

> No statement made by or on behalf of the Insured, whether contained in the application or otherwise, shall be deemed to be a warranty of anything except that it is true to the best of the knowledge and belief of the person making the statement.

A concealment in the law of insurance is the designed and intentional withholding of any fact, material to the risk, which the insured in honesty and good faith ought to communicate. Furthermore, in the absence of fraud, a failure of insured to disclose a fact with reference to which no questions are asked is not such a concealment as will void a policy. *Graham v. Aetna Insurance Co.*, 243 S.C. 108, 132 S.E.2d 273 274-75 (1963).[16]

The evidence would support a jury verdict that the insured, to its best knowledge and belief, had no knowledge of prior dishonest acts on the part of Barksdale. Such a determination is for the jury; the words "knowledge and belief" imply a subjective test as to insured's actual state of mind, rather than an objective, "reasonable man" test. Again, assuming *arguendo* that the insured had actual knowledge of dishonesty, there is still the question of the materiality of the risk. The record in this case does not support a determination that the failure to disclose Barksdale's certifications regarding the preadvances was material to the risk undertaken by INA and Hartford. The practice of preadvancing funds was halted immediately upon discovery, no loss was incurred as a result of the practice, and the practice did not involve any intent to defraud. The insurance companies have not presented evidence sufficient to justify holding as a matter of law that the insured failed to disclose facts material to risk being undertaken by the insurers. The evidence adduced at

[16]This South Caroiina case dealt with a previous fire loss which was not disclosed to the insurance company. It is argued that the issuance of a Blanket Bond requires the application of a different rule. Research does not disclose any South Carolina law making this distinction. In the present case, no advance inquiries were made by INA or Hartford.

trial presented a question of fact for the jury. It was error to take the verdict from the jury. I would reverse the judgment of the trial court, both on the facts and on the law, and reinstate the verdict.

APPENDIX C

IN THE
United States Court of Appeals
For the Fourth Circuit

No. 77-2246

C. DOUGLAS WILSON & CO., a South Carolina corporation — *Appellant*

vs.

INSURANCE COMPANY OF NORTH AMERICA, Philadelphia, Pennsylvania; HARTFORD ACCIDENT AND INDEMNITY COMPANY, Hartford, Connecticut; and ST. PAUL FIRE AND MARINE INSURANCE COMPANY, St. Paul, Minnesota — *Appellees*

Petition for Rehearing and Suggestion of Rehearing in Banc

PREFACE

"I am disturbed that an important case such as the one at bar is disposed of by reference to one district court opinion which is factually inapposite."[1]

"The district court based nonliability on two theories . . . Neither theory is applicable to the circumstances of this case."[2]

"The apparent lack of inclination to thoroughly discuss the authorities on the part of the panel majority, and to a somewhat lesser extent by Judge Chapman, prompts the writing of this lengthy dissent."[3]

"*Peurifoy v. Loyal, surpa,* is not cited, mentioned or dis-

[1] Dissenting opinion of Judge Hoffman, p. 30.
[2] *Id.* pp. 39-40.
[3] *Id.* p. 29.

cussed in either the opinion of the district court or the opinion of the panel majority."[4]

"The panel majority and Judge Chapman have disregarded the admonition of our great Chief Judge Parker . . . in *Burcham v. J. P. Stevens & Co.*, 209 F.2d 35 (4th Cir. 1954) . . . ."[5]

"The opinion of the panel majority and the able opinion of Judge Chapman each fail to discuss the *issue of intent* which, according to law, is critical."[6]

PETITION FOR REHEARING IN BANC AND SUMMARY OF ARGUMENT

Pursuant to Rules 35 and 40, C. Douglas Wilson & Co. (CDW) respectfully petitions for a rehearing and suggests the appropriateness of a rehearing in banc. Mindful of the standards set forth in those Rules, CDW submits the following factors for the consideration of the Court:

(1) The panel majority has disregarded the standards established by Judge Parker for determining whether an employer is to be charged with knowledge of prior dishonest acts of its employee. *Fidelity and Deposit Co. of Maryland v. People's Bank of Sanford*, 72 F.2d 932 (4th Cir. 1934).

(2) The panel majority has disregarded the controlling law of the State of South Carolina, failing to discuss or even mention South Carolina authority establishing the weight to be given to the state of mind of the officers and directors of the employer. *Peurifoy v. Loyal*, 154 S.C. 267, 151 S.E. 579 (1930).

(3) The panel majority has misapprehended the principal position of CDW to be that the prior acts of its employee were not dishonest. While

[4] *Id.* p. 38. (*Peurifoy v. Loyal*, 154 S.C. 267, 151 S.E. 579 (1930).)
[5] *Id.* p. 39.
[6] *Id.* p. 33.

that is an issue, the principal position of CDW is that the question of whether CDW should be charged with *knowledge* of prior dishonesty was a jury issue under controlling authorities. The panel majority fails to address the issue.

(4) The panel majority has misapprehended the nature of the fidelity bonds involved in this case by giving retroactive effect to their termination provisions.

(5) The panel majority has disregared the standards set forth by Judge Parker with regard to the consideration of the evidence on a motion for judgment n. o. v. *Burcham v. J. P. Stevens & Co.*, 209 F.2d 35 (4th Cir. 1954).

INTRODUCTION

The trial of this case was quite lengthy, the Order of the lower court runs 36 pages, the opinion of our panel majority 10 pages, and the dissenting of Judge Hoffman 36 pages. We have the difficult task of conveying in a very few pages the basis for our belief that this is a most important case, wrongly decided by the panel majority, whose decision conflicts with principles of law uniformly recognized by this Court and by courts throughout the country. We urge the thorough reading of Judge Hoffman's strong, well-reasoned, and detailed dissenting opinion.

The case involves fidelity bond coverage and the defense that the insured (CDW) had knowledge of prior dishonest acts of an employee (Barksdale). The jury returned a verdict for CDW, and the issue is the propriety of judgment n. o. v. granted by the trial court. All that CDW need do to *require* the reinstatement of the jury verdict is to demonstrate the existence of a jury issue. In so doing, every conflict in the evidence must be resolved in favor of CDW and every favorable conclusion or inference that can be drawn from the evidence must be drawn.

In requesting rehearing or rehearing in banc, CDW

does not seek a rehearing as to issues involving the defendant St. Paul Fire and Marine Insurance Company. The rehearing is requested only as to issues involving the defendants Insurance Company of North America and Hartford Accident and Indemnity Company.

ARGUMENT

Knowledge of Prior Dishonestly

It is most respectfully submitted that the majority completely disregarded controlling principles of law established by this Court speaking through Judge Parker in *Fidelity & Deposit Co., of Maryland v. People's Bank of Sanford,* 72 F.2d 932 (4th Cir. 1934). This decision was cited in Appellant's Brief (p. 30) and in Judge Hoffman's dissent (p. 38). It establishes certain criteria by which cases of this nature are to be governed,[7] and yet the majority did not so much as make reference to it. The majority additionally fails to discuss the law of the State of South Carolina, and in particular the case of *Peurifoy v. Loyal,* 154 S.C. 267, 151 S.E. 579 (1930), which establishes similar criteria. Even though the present case is unquestionably controlled by South Carolina law under diversity principles, there is no mention whatsoever of South Carolina law on this issue in the majority opinion.[8]

The failure even to mention the *Bank of Sanford* and *Peurifoy* cases clearly demonstrates the misapprehension of the panel majority when they set forth their perception of the pivotal issue. The majority opinion (p. 6-7) deals exclusively with the question of whether Barksdale's conduct

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[7]In particular, it establishes that the subjective reactions of the employer are factors to be considered by the trier of fact, under a "reasonable man" analysis, in determining whether the employer has knowledge of prior dishonesty. In taking the present case from the jury, the lower court and the panel majority have effectively held that such factors are not to be considered.

[8]This failure is not cured by the majority's reference to Judge Chapman's Order of July 8, 1977, which does not mention South Carolina law or cite a single South Carolina case, and which mentions the *Bank of Sanford* case only with reference to an unrelated issue (App. 577).

was dishonest and states (p. 7) that Appellant's argument hinges upon the distinction between Barksdale's false certifications concerning pre-advances and those concerning letters of credit. Admittedly, this distinction exists and was argued; however, the pivotal issue does not concern itself with this distinction, but rather with the subjective test—the reasonable man test—which is applied by this Court and by the Supreme Court of South Carolina in the *Bank of Sanford and Peurifoy* cases, *supra*. That is, the primary question is not whether Barksdale's acts, discovered by CDW on March 19, were dishonest, but whether the knowledge CDW officials had "would inform an ordinary, reasonable and sensible employer that dishonesty had occurred which might involve the bonding company in a loss."[9] This is the pivotal issue—the issue which manifestly created jury issues and requires the reinstatement of the jury verdict, and the important issue which merits reconsideration of this case because the majority opinion would result in a substantial change in the law of this Court.[10]

The principles of *Bank of Sanford* and *Peurifoy* are universal. Judge Hoffman discusses a number of authorities in his opinion (pp. 22-29) and notes that they are "only a sam-

[9]This quote is taken directly from Judge Chapman's charge to the jury, to which no exception was taken. (App. 473, lines 20-22.)

[10]Detailed factual discussion is both inappropriate and impractical in this petition. However, the facts creating a jury issue on this question are overwhelming and should be mentioned. Under the standards of review applicable in light of the jury verdict, the following are only a few of the facts which unquestionably apply to this case:

Barksdale was the only employee of CDW who knew anything at all about HUD requirements and procedures concerning the type of loans in question. He did not conceal the practice concerning loan advances which the majority now finds to be dishonest, but rather explained that HUD was aware of the manner in which he handled the advances and did not disapprove of it. *All officers of CDW believed Barksdale's explanations.* No officer of CDW even suspected that Barksdale's conduct was dishonest at the time.

None of these facts are questioned by either the panel majority or Judge Chapman. They are mandated by the jury verdict if there was evidence to support them, but actually they are unquestioned in the record.

ple of the many cases which could be cited" (p. 29). The Eighth Circuit expresses the principles concisely in *USF&G v. Empire State Bank*, 448 F.2d 360, 365 (8th Cir. 1971):

> Discovery thus imports an awareness of the *significance* of known facts . . . . "[N]ot only must the facts be known, but they also must be recognized for what they are . . . ."
>
> . . . .
>
> [T]he *trier of fact* must find the pertinent underlying facts known to the insured and *must further determine subjective conclusions reasonably drawn therefrom by the insured.*
> (Emphasis added.)

The majority opinion holds that Barksdale's actions as to loan advances were dishonest as a matter of law and states that CDW officers knew of those actions. However, it fails to address the pivotal question of whether these officers were aware of the *significance* of the facts known to them. *Bank of Sanford*,[11] *Peurifoy*,[12] and the "reasonable man" test

[11]In *Bank of Sanford* the precise question at issue in the present case was presented—whether the employer had knowledge of prior dishonest acts of the employee. As the trier of facts in that nonjury case, the trial court relied upon the employer's subjective reactions to the prior acts, which were admittedly violations of state banking law. "Evidently the officers of the bank believed . . . that his intentions were free from wrong . . . ." (72 F.2d at 937). The lower court applied a reasonable man test. "It is unreasonable to conclude that the bank would have retained him . . . if it thought he was unworthy of trust." Speaking for this Court, Judge Parker approved this analysis and affirmed the lower court. By its verdict in the present case, the jury made similar factual determinations. If the jury verdict is overturned, *Bank of Sanford* is necessarily repudiated.

[12]In *Peurifoy* the question was whether the employer had failed to give prompt notice to the surety upon discovery of a dishonest act, so that the time of discovery of dishonesty was the crucial factor as in this case. The jury returned its verdict for the employer. In affirming the denial of the surety's motion for directed verdict, the South Carolina Supreme Court relied upon the subjective reactions of the bank officers. "They believed the matter to be an irregularity, but not a dishonest act." (154 S.C. at 297, 151 S.E. at 589.) The failure of the majority even to consider the unquestioned reactions of the officers of CDW is directly contrary to South Carolina law as expressed in *Peurifoy*.

adopted by courts, both state and federal, throughout the nation require that "the trier of fact . . . must further determine subjective conclusions reasonably drawn therefrom by the insured." *Empire State Bank, supra.* The failure of the majority to reinstate the jury verdict under these authorities, or even to address the question, constitutes clear error.

The law of South Carolina mandates that the bond provisions in question be interpreted most strongly in favor of coverage for CDW, and this principle is consistently given controlling effect by the South Carolina Supreme Court in such cases. The insurers had the burden of showing that CDW had such knowledge of employee dishonesty as required it to give notice to the insurers. To say *as a matter of law* that CDW failed to give notice of employee dishonesty of which it was aware is to say *as a matter of law* that CDW actively defrauded the insurers by failing to reveal knowledge in its possession prior to the filing of these claims.

Rather than discussing the controlling law of this Court or the controlling South Carolina law, the panel majority relies solely on an Ohio District Court case, *City Loan and Savings Co. v. Employers' Liability Assurance Corp.*, 249 F. Supp. 633 (N.D.Ohio 1964), which is apparently adopted as the controlling law of this Circuit. Application of the *City Loan* case to the pivotal question of whether the jury verdict in this present case should stand, however, is completely inappropriate and will radically change the law of this Court. The *City Loan* case was heard by District Judge Battisti *without a jury*, and his Order makes no pretense of establishing guidelines for the withdrawal of a case from a jury. There are numerous substantial points distinguishing the *City Loan* case, set forth in Appellant's Brief (pp. 9-12) and in Judge Hoffman's dissenting opinion (pp. 29-30). Without question, the case is "factually inapposite."[13]

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[13] Opinion of Judge Hoffman, p. 30.

Discovery Bond Provisions

Judge Hoffman cogently demonstrates in his opinion (pp. 42-44) that the panel majority misapprehends the nature of the fidelity bonds involved in this case by giving retroactive effect to their termination provisions. The majority responds to Judge Hoffman's argument in a footnote (p. 8):

> But here, the dissent would have INA and Hartford assume liability for losses resulting from acts committed before the inception of their respective policies by an employee who was *never* within the coverage of the policies. This is an untenable result.

This is clear error on the part of the majority. The fact that the insurance industry writes fidelity bonds on a "discovery" basis makes such a result not only tenable, but clearly within the contemplation of the contracting parties. When a bond is written on a discovery basis, it is undeniably contemplated that the bonding company may become liable for losses incurred by the insured for dishonest *acts* committed prior to the time the bond becomes effective and for losses occasioned by persons who may never have been within the coverage of the policy currently in effect. Bonds issued on a discovery basis ofttimes protect the insured from losses occasioned by former employees. The INA bond is written on such a discovery basis, specifically providing that it insures CDW for "any losses . . . sustained by the Insured *at any time* but discovered during the Bond Period." (App. 490.) (Emphasis added.) The Hartford bond has the effect of a discovery bond in this case because of its substitute coverage provision.[14]

The striking contrast between the unassailable logic of Judge Hoffman's dissent, with supporting authorities, and the summary treatment by the majority, without any supporting authority, cannot be overlooked. The majority has

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[14]See the discussion in Judge Hoffman's opinion, footnote 13, page 17.

misapprehended the very nature of the fidelity bonds in question, and by its opinion places the status of discovery bonds in serious doubt in this Circuit.

Precedent

This is a most important case. Its importance to the parties includes the fact that it involves an amount in excess of a million and a quarter dollars. Its importance to this Court centers on the departure of the majority opinion from well established principles of law entrenched in prior decisions of this Court and of courts, both state and federal, across the nation. It is respectfully submitted that, if the majority opinion is allowed to stand, this Court will be faced with the task in future appeals of finding ways to limit this decision, or more likely will find it necessary to specifically overrule or reverse it.

The posture of this case is most significant. It is before this Court after the granting of judgment n. o. v., which means (paraphrasing *Mays v. Pioneer Lumber Corp.*, 502 F.2d 106, 107 (4th Cir. 1974)):

> If, giving CDW the benefit of *every legitimate inference* in its favor, there was evidence upon which the jury could reasonably return a verdict for it, we *must* reverse the judgment below.

This Court, in *Wratchford v. S. J. Groves & Sons Co.*, 405 F.2d 1061, 1063 (4th Cir. 1969), has described the right to have disputed factual matters determined by a jury in a civil case as a "fundamental right," explaining that:

> The right to a jury trial and our traditional faith in the jury's capacity to resolve factual disputes is basic to our federal system of judicial administration.

Likewise, in *Harner v. John McShain, Inc. of Maryland*, 394 F.2d 480, 481-82 (4th Cir. 1968), this Court reversed a judgment n. o. v., quoting:

> "In federal courts, at least, the Seventh Amendment writes into the basic charter the belief that trial by jury is the normal and preferable mode of disposing of issues of fact in civil cases . . . . The Supreme Court has been zealous to safeguard, perhaps even to enlarge, the function of the jury."

In light of these principles, in light of the jury verdict in favor of CDW, and in light of Judge Hoffman's strong dissent pointing out the consequences of the majority decision, the decision of the majority taking from the jury the factual question of whether CDW had knowledge of prior dishonesty will constitute a strong and important precedent contrary to the present law as expressed in *Bank of Sanford*. Yet, with no discussion of the legal principles involved, the majority would adopt standards different from those uniformly applied by courts throughout the country.[15] For these reasons it is submitted that this is a most important case warranting reconsideration by this Court.

CONCLUSION

In this petition, Appellant has suggested that in several particulars the panel majority misapprehended the legal principles governing this appeal. The failure to discuss South Carolina law or the *Bank of Sanford* case, the failure to discuss the awareness of CDW officers of the significance of facts known to them, the failure to discuss and apply the "reasonable man" test applied uniformly throughout the country, the failure to appreciate the significance of the fact that these were *discovery* bonds expressly covering acts occurring before their effective date – all these factors combine to demonstrate this misapprehension. Perhaps the explanation is the style and detail of the lower court order, which may have obscured its serious shortcomings and omissions. Whatever the reason, the present majority opin-

[15]See, for example, the cases discussed by Judge Hoffman at pages 22-29 of his opinion, which he correctly describes as "only a sample of the many cases which could be cited." (p. 29)

ion results in serious injustice in the present case, and establishes a bad precedent in a particularly important case.

The conclusion of the panel majority's opinion attributes CDW's "unfortunate position" in part to the "poor judgment of its own officers." The majority thus recognizes that it was a judgment call for these officers, which is the essence of our argument. The question is not whether CDW officials possessed knowledge of acts on the part of Barksdale which may now be considered dishonest, but rather the question is their "awareness of the *significance* of known facts . . . . '[N]ot only must the facts be known, but they also must be recognized for what they are . . .'"[16] Judge Chapman stated basically the same thing during discourse with counsel prior to his charge where he said:

> "And that gets back to a Jury question: What did they know at the time and *what would a reasonable person have done at the time.*" (Emphasis added, App. 450)

To repeat, and to state otherwise, the question is whether the knowledge CDW officials had "would inform an ordinary, reasonable and sensible employer that dishonesty had occurred which might involve the bonding company in a loss."[17] Again, as the Eighth Circuit put it:

> [T]he trier of fact must find the pertinent, underlying facts known to the insured and must further determine subjective conclusions reasonably drawn therefrom by the insured.[18]

The evidence creating a jury issue in this case is overwhelming. Appellant respectfully requests that it be given the opportunity to demonstrate this fact to the Court upon rehearing and reargument, to avoid an unjust result in this important case and to prevent a bad precedent for future cases.

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[16]USF&C v. Empire State Bank, 448 F.2d 360, 365 (8th Cir. 1971).
[17]See footnote 9, *supra.*
[18]USF&C v. Empire State Bank, *supra.*

APPENDIX D

United States Court of Appeals For the Fourth Circuit

No. 77-2246

C. Douglas Wilson & Company,
a South Carolina Corporation,

Appellant,

versus

Insurance Company of North America, Philadelphia, Pennsylvania; Hartford Accident and Indemnity Company, Hartford, Connecticut; and St. Paul Fire and Marine Insurance Company, St. Paul, Minnesota,

Appellees.

Order

Filed Feb. 21, 1979

Upon consideration of the appellant's petition for rehearing and suggestion for rehearing en banc, and no judge having requested a poll on the suggestion for rehearing en banc,

It is ADJUDGED and ORDERED that the petition for rehearing is denied.

Entered at the direction of Judge Hall with the concurrence of Judge Butzner. Judge Hoffman dissents from the denial of petition.

For the Court,

/s/ William K. Slate, II
Clerk